

11-1930

Journal of Accountancy, November 1930 Vol. 50 Issue 5 [whole issue]

American Institute of Accountants

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The JOURNAL of ACCOUNTANCY

VOLUME L

NOVEMBER, 1930

NUMBER 5

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Issued Monthly by

THE JOURNAL OF ACCOUNTANCY, INCORPORATED, *Publishers*

Publication Office, 10 Ferry Street, Concord, N. H.

Editorial and General Offices, 135 Cedar Street, Manhattan, New York, N. Y.

President, CARL H. NAU
3334 Prospect Ave.
Cleveland, Ohio

Treasurer, J. E. STERRETT
56 Pine Street
New York, N. Y.

Secretary, A. P. RICHARDSON
135 Cedar Street
New York, N. Y.

Entered as second-class matter at the Post Office at Concord, New Hampshire, under Act of March 3, 1879

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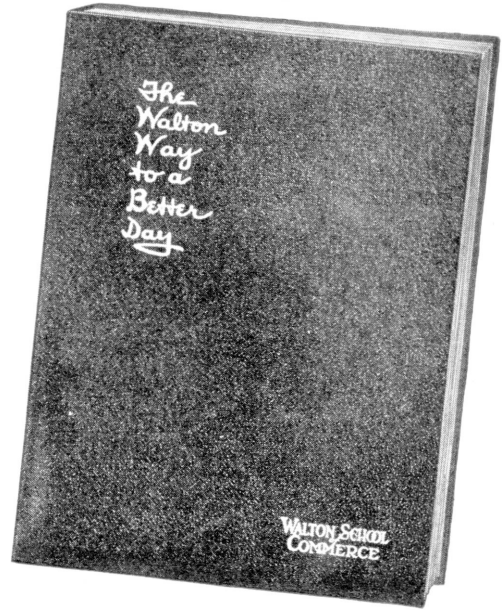
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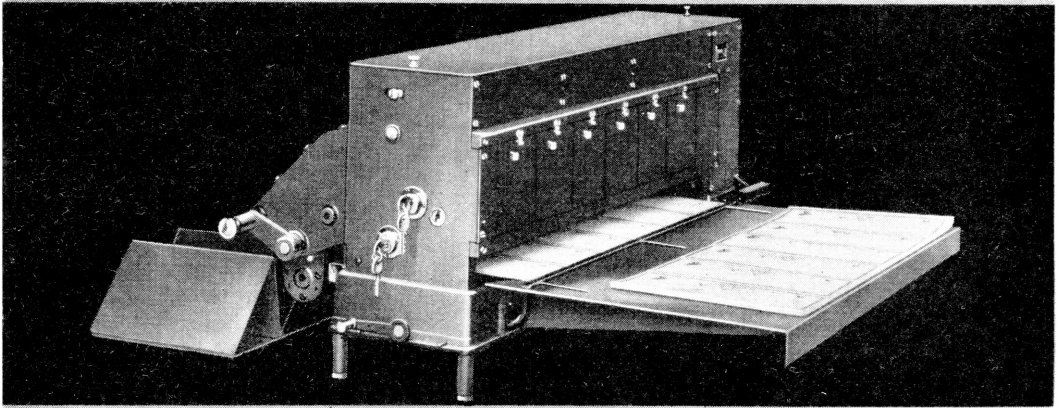
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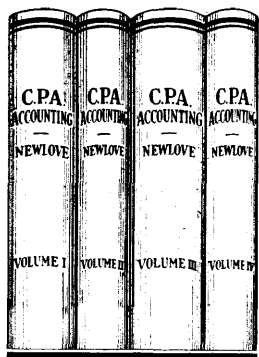
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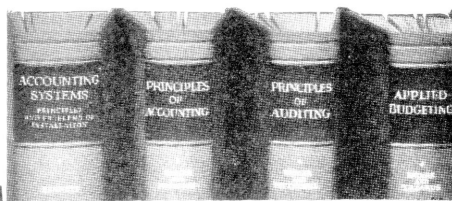
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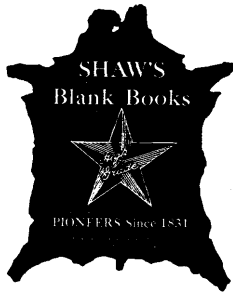
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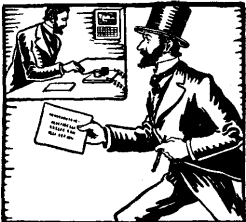
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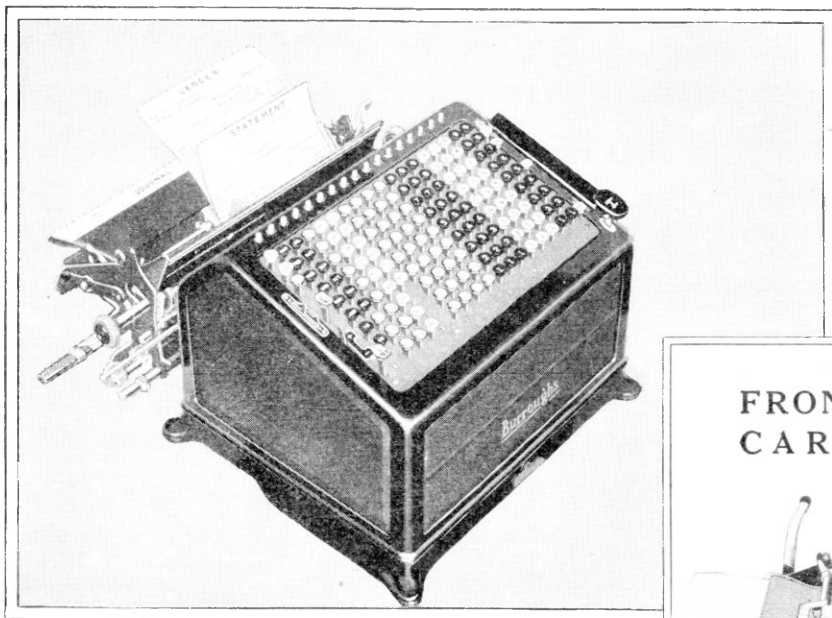
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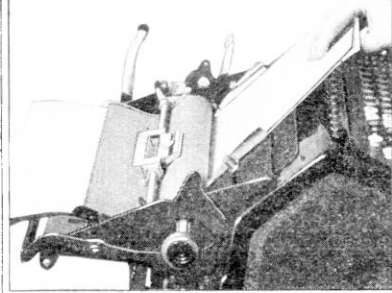
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Vol. 50

NOVEMBER, 1930

No. 5

EDITORIAL

The Voice of the Young Men

One of the most interesting features of the recent meeting of the American Institute of Accountants at Colorado Springs—leaving out of consideration for a moment the majestic beauty of the surrounding mountains and plains from which it was difficult to turn to the prosaic matters of convention—was a series of papers by younger members of the Institute. There were in all five such papers, none of which was written by a charter member of the Institute. Some of the authors are men employed by large firms. Others are practising individually or in partnerships. They represented therefore all classes of professional activity. Now it might have been expected that some of these young men would adduce revolutionary notions. We have been told so often that the ideals of the established leaders of accountancy are not shared by the present generation that it would be reasonable to look for radical proposals. It has been said that the system of ethics to which the Institute has adhered is outworn and should be abandoned. Certain vocalists have been saying that the standards of education, practice and examination set by the Institute should be lowered because the youthful members of the profession would have it so. Some orators, lured into the land of topsy-turvy by the sound of their own voices, have been telling all who would listen that in order to advance the profession must go backward—that by admitting everyone who seeks admission the Institute will render membership valuable. And the frequent argument of these little fellows with loud tones is that youth will be served—which seems to mean badly served.

**Demand for Higher
Standards**

There is always a difference in the opinions of men. If it were not so, how intolerably monotonous would be the meetings of men. There are some accountants who think that the ethical and other standards now in force are perfect, some that they are fairly good, others that there should be changes upward or downward. And that, of course, is as it should be. But the young men at Colorado Springs behaved quite astoundingly. They did not give any evidence of the iconoclastic proclivities which are supposed to sway them. They adopted instead a stout stand for the so-called conservative policies and even urged, with a remarkable unanimity, that the standards be raised still higher. Apparently there could have been no preliminary agreement among them to speak in chorus. They came from different sections of the country and were strangers to each other. Yet in all that they said one could hear the undertone of loyalty to the high principles which have made the Institute strong. In the course of discussions at the meetings and in personal conversation one heard always expression of the same desire that there must be a higher and higher standard. The amendments of by-laws which were proposed and passed without dissenting vote will require, if approved in the referendum, longer preliminary practice and will give the examining board power to exercise more careful selection in the acceptance of applications. There is a point which it would be unwise to surpass in the raising of barriers to admission. It would be folly to make demands which would shut out the truly desirable men, and it is conceivable that any organization of a professional character can become so exclusive as to defeat its own purposes. That, however, is not probable. As a rule it may be safe to say that the maintenance of lofty standards strengthens an organization, makes membership in it more keenly to be desired, increases steadily its influence upon the public and best serves its day and generation. Some of the fathers in Israel may have wondered a little about the sentiments of the new-comers and a few, slightly timorous, may have felt that perhaps it might be well to concede something to the subversive ambitions of the young men, of which so much has been said. It will be a pleasant revelation to doubters to read what the obstreperous youths have to say. Apparently they know what they want. They would have high standards made higher. So far as the new members are concerned the motion to advance is carried unanimously.

**The World Enjoying
Gloom**

It is the vogue to speak of the depression of business which is weighing down the world. Newspapers and magazines are writing about it. Every other fellow who crowds his way to the front of the rostrum for a clamatorial moment puts his breath to the task of explaining the condition and predicting the change for better or worse which must soon ensue. People who are not greatly affected by the state of affairs—men, for example, like members of college faculties whose income, generally far too small for perfect peace, is nevertheless fairly certain to be received—are loudest in their exposition of the case. Everybody, even the man out of work whose family is looking forward to a drab and chilly winter, is talking of hard times. It is the duty of the leaders of business, finance and politics to discern and point out to the rest of us every indication of the coming dawn—and they are doing their best. But sometimes it seems that there may be a little too much protestation. Every sailor who has done his trick at the wheel, when perhaps the young moon has set at the close of the midwatch and the stars seem tired and the sky is deep, cloudless black, knows that there is an exhilaration in turning his eyes from the lubber's mark or the weather leech of the topsails and seeing, first in fancy, then in positive reality, a greyness in the east. When that appears it drags up after it a multitude of colors and with amazing speed the sun itself sets fire to the darkness—and day is here. Now the men who are on watch at the head of affairs think that the grey dawn is beginning—at least they say so, and probably they are truthful. There is a prospect of morning—indeed while the mechanics of our solar system control there is always a reasonable assurance that light will return. But the point which sometimes seems to have been overlooked is that in our eagerness for a much-advertised daybreak we may be engaging temporarily in an orgy of morbid grief, not altogether justified by the condition of the weather or the position of the sun.

**Economics of Instal-
ment Buying**

In the course of a good, inspiring speech at Cleveland the other day the president of the United States displayed a confidence in the existing as well as the future stability of this country's business. And in his usual logical way he explained the faith that is in him. One point upon which he laid stress seems to have called forth comparatively little comment in the press,

but it has a wide significance. He mentioned the subject of instalment buying and it was apparently his belief that we may look soon for a resumption of this method of exchanging money and merchandise. There is a good deal of sound argument, as well as argumentative sound, on both sides of this question. People who believe that it is well to encourage the buying of everything from real estate to underwear by pledging income which may never be received have an abundance of reasons for their opinion. The conservatives who cling to the old-fashioned theory that it is wise to spend only what one has, and not all of that, can marshal an equally imposing array of reasons for their opinion. Probably true wisdom marches, as it usually does, in the middle of the road. It seems to us that instalment buying of homes, which are desirable for all and may be expected to have a value when the last payment has been made, may rightly be encouraged. But it is impossible for us to see any virtue whatever in the contention that motor cars, pianos, radio "sets," furniture, clothing, vacuum cleaners and saxophones should be bought by everyone who has or can borrow enough money for payment of the first instalment. It is too much like sitting down to dice with Death, Fate and shrouded Future as players. It is far pleasanter to know one's partners and opponents. Books of length and imposing appearance have been written about the principles and effect of instalment sales. The advantage of keeping money in circulation has been expounded. All that can be said for and against the practice has been said again and again and it all comes to this: that one approves and one condemns. It is true enough that the people would not have things which they now enjoy—at any rate they would not have them so soon—if they could not buy by pledging their expected earnings. But, on the other hand, if they would save they would be able to buy at lower prices and they would feel that what they had in their homes was not in peril of going away on the backs of furniture movers. We believe that the greater sense of firmness and assurance in a scheme of cash purchases would more than compensate for a loss of the transitory joys of momentarily terminable possession.

**Buyers Are
Waiting**

At such a time as the present there is naturally a sharp decline in the volume and variety of instalment buying. When men and women are out of work they find difficulty in con-

vincing sellers that their credit is "good." And so people are managing somehow to get along without a new car, and last winter's fur coat will have to go through one more season. In many houses there are voids left by the taking off of partly owned and now wholly unowned merchandise. As a nation, we are, however, so addicted to the plan of articulated payments that we are merely awaiting the first faint hint of reviving income to throw wide the doors to the instalment agent. It is quite absurd, but true nevertheless. And however unsound the whole custom may be it will have a stimulating effect upon business when activity begins. It is incontrovertible that part-paying is at low ebb. Most of the articles for which payments had to be completed in one or two years have now passed to the new owners upon completion of payment or have been taken back by the vendors. Instalments payable out of current income are comparatively small. People whose salaries or other revenues have been reduced are now relieved of the burden of contract payments and, in consequence, they can struggle along more happily than would have been possible had the loss of work or the reduction of income fallen suddenly in the midst of the life of a dozen or more instalment agreements. This means that while concerns selling chiefly on the part-payment plan are seriously injured by the shrinkage of business, people who buy, except those who have no work, are better off than they were, and for the present at least they are conserving their resources with a caution that is bound to conduce to economic health and the recapture of that prosperity which it is our good fortune to regard as normal.

**The Pangs of
Transition**

When the money, which is now held back in half hesitant fear, is released there will be a steady growth of active buying and, much as some of us deplore the excesses to which "deferred payment" sales lead, it must be admitted that the recovery which seems near at hand will be assisted materially by the instalment buying which will begin the moment the public's confidence is restored. When President Hoover spoke of this matter at Cleveland he was thinking no doubt, not only of the ordinary increase of business which might be expected in any improvement of conditions, but also of the accumulating resources which will find outlet at the end of the depression. The chief cause of the halt in business is the spectre of fear which haunts high places and low. If the

people could be persuaded to forget those preposterous days of soaring markets, exorbitant wages and extravagant orders; if they could be induced to compare 1930 with sane years before the crazy era of boom; if, in a word, they could be given a sense of far-perspective, we should not hear much about bad times. True, there is a tragic amount of unemployment, but that is partly the effect of over-employment to meet the extraordinary demands of the financial banquet. Hosts of extra servants were needed for that hilarious occasion, and the sad part of it was that they thought they had permanent positions in the menage. They are now going through a doleful period of transition when some of them are like to feel the pangs of hunger. Would to God that idleness could be avoided, but it seems that it can not. The best that can be said about it is that in this blessed land idle days are brief. As a rule a man who is able and willing to work need not stand long in the market place waiting for someone to hire him. Aside from the fact and effect of the present prevalence of unemployment there is nothing in the condition of affairs here to cause alarm. America, perhaps alone among the nations, is doing pretty well and it might be a good plan to think so. We are getting back to normal business and the 1913 dollar, after war and an unhealthy riot of success. The process is painful but necessary and, indeed, salutary.

**Accountancy and
Broad Vision**

“There is something inherent in the work of an accountant which makes him, as a rule, meticulous, narrow, concerned wholly with the details to the forgetting of the big world and of them who walk therein.” That is quoted from the comments of a man who has spent a rather long life in the field of statistics, with holiday excursions into the higher land of economics. The quotation is not absolutely verbatim, perhaps—it is made from memory—but the sense is correctly given. This man has been looking over the boundary which separates accountancy from his own domain and he believes that he is competent to speak with some authority as one who has watched the accountant at work and play. And it must be confessed that there is far too much of truth in the accusation to be dismissed with a wave of the hand. It may not be quite fair to speak of accountancy as a cause of over-concentration. There is in accountancy as in every other science abundant opportunity for broad, farseeing

scholarship and a splendid philosophy. The fault is in ourselves that we are underlings. One may make accountancy or any other path in life a highway to the hills or a descent to a sunless cave. The path is not the cause of our walking backward in it. There is no vocation nobler nor more sacrificial than the Christian ministry and yet even in that one finds small as well as great souls. Is the church to blame? If, then, it be found that a man's occupation is not the measure of his vision nor the chart of his behavior it must appear that the man himself is the culprit if he err.

A Parable

There was, once upon a time, a babu in an office on the Himalayan foothills who had labored through the night seeking an elusive error of six annas in the books of the station. He stared at the figures before him so long and so steadily that they burned themselves into his brain and he became blind to everything beyond the scrawled pages. But ever running on ahead of his eyes as they traveled up and down the paper were those fugitive six annas and he could not overtake them. It became a race for life. His brain began to whirl, but still the six devils pointed their fingers at him and screamed in derision. It was all of no avail. He was a beaten man. The world was a dreadful place from which he longed to depart. He sat back with his head bent forward. Outside the window a little greyness supplanted the darkness. The dawn came up. Suddenly the sunrise glory flamed on Everest. Dazzling splendor spread over all the peaks. Rose red, blue, green, gold and all the colors of the spectrum made their entrances and their exits on height and slope and over valley. The day had come. Clear and perfect whiteness covered the tremendous range. And in the little office on the foothills a babu sat hunched up and purblind. There was a better light upon the pages of the book, reflected from the snowy heads of mountain giants, and by the help of that light the keeper of accounts pushed on again in chase of the fleeing six. He did not look up to see the wonder of the world.

The Moral Applied

Now this, of course, is allegory, and allegory, as everyone knows, is a form of writing whose purpose it is to tell truth in the guise of fiction, but one also knows well that the moral is always applicable to one's friends and acquaintances. Every accountant can think of some

fellow of the craft who is such a quill-driver as that blockhead of a babu. "Those two accountants who have an office across the corridor are not a bit better. They stick to it night and day—they are dull and self-centered. They do nothing for the general welfare of the profession, or of the public either for that matter. All they think about is getting an engagement. And they seem so well pleased with themselves that it is positively disgusting to attempt to be friendly with them. That story about the babu must have been written about them. It is a pity, though, that they are such slaves to their work." And if we listen at the door of the office across the corridor we shall hear one say, "Old Duffer is at his desk over there working on a set of books. When you pass by look in. You'll see him bent double. He does not know that the sun is shining on Puget Sound—or the Hudson—or Rocky Mountains. He is one of those small minded creatures who can not forget the days when he was a fifteen-dollar book-keeper."

Great Opportunities It is the custom to say that a shoemaker must stick to his last and an accountant to his figures, but these adages are not entirely true. No one should look so fixedly at minutiae that he can not see the mass. It may as well be admitted that accountants have often been guilty of a pernicious littleness. They have not always taken advantage of the wide range of thought which opened before them. They have been, like all other men, far too much concerned about the tangible. But, fortunately, not all accountants are thus deficient, and there is an increasing tendency to breadth of knowledge and interest. Some time ago we urged that accountants give more attention to the study of economics, and this seems desirable not merely because of the specific subject but also because anything which can expand the scope of one's learning is good. There is a brilliant future before the accountant who can take part in the march of progress which now goes forward. Indeed it is impossible to set any limit to the value of the service which an accountant can render to the whole community in which he lives and to the general advance of humanity. The myopic old fellows who spent their days and nights in juggling figures largely for the sake of juggling have no place in the procession. They might be set up on a float of purely historical significance. They mark a stage in the progress of affairs like the velocipede or the

first Ford car. We owe them a debt of gratitude for their persistence and a little for their improvement of technique, but the new generation will not follow them in their limitation. The new accountant is a different being. He may not yet be altogether above the reach of a charge of short-sightedness. He is not sanctified. But there is a great change in the ways and thoughts of the foremost men in the profession. The accusation which is the basis of these notes is not merited by all accountants. It is deserved by a few, but they are not important and their very smallness makes them negligible. As the procession moves on we shall lose sight of them in the distance.

American Institute of Accountants

REPORT OF THE PRESIDENT *

By FREDERICK H. HURDMAN

One year ago, at Washington, you accepted the invitation of Colorado Springs to hold your next annual meeting in this altogether delightful spot. It seems that your choice has been a happy one and even those of you who have come a long way I am sure will feel no regret.

In this the second year of office as your president it is my opinion that there have been many important developments. You will find in other reports a complete review of the year's activities. I shall mention a few only.

During the past year many parts of this country have been visited by your president and secretary. It is believed that these trips are of great value in creating a better understanding of what the Institute means to the profession. Last December it was my privilege to attend at Montreal the fiftieth anniversary celebration of the founding of the Institute of Chartered Accountants in Quebec. Your president and editor represented the Institute in London, England, last May at the fiftieth anniversary of the granting of the charter to the Institute of Chartered Accountants in England and Wales. At the same time we were entertained by the Society of Incorporated Accountants and Auditors. On that occasion many of the friendships made when our cousins from overseas visited us in Washington a year ago were renewed and strengthened. Early this month I attended the annual meeting of the Dominion Association of Chartered Accountants at Halifax.

The arrangement effected during the year whereby The Century Company will publish and distribute books on accounting selected and edited by the Institute should add greatly to its prestige and improve the quality of accounting literature produced in the future. Your officers are not so much concerned with profits to be derived from this venture as they are in producing books by capable authors on subjects on which there appears to be a lack of good material at present.

* Delivered at the annual meeting of the American Institute of Accountants, Colorado Springs, Colorado, September 16, 1930.

As a result of this undertaking it seemed wise to make a change in the personnel in order that A. P. Richardson, who had for so many years very ably filled the position of secretary and editor, could devote all his time to editorial work. Accordingly, as of January 1, 1930, Mr. Richardson has occupied the position of editor and Mr. Carey has served as secretary. Under this arrangement I believe the Institute has two extremely capable officers serving in positions for which each is well suited.

From time to time the Institute has been asked to express an opinion on questions of accounting procedure. Many of these questions were disposed of through the work of special committees created for the purpose, but it has been felt that the Institute should have a special or standing committee on accounting procedure which might consider problems of procedure arising from time to time in our practice and make some pronouncement which would have weight. With the approval of the executive committee such a committee was appointed during the past year, its membership being composed of representatives of the larger firms with offices in New York, in order that we might have the benefit of the larger experience of those firms and have it quickly. A matter of importance is now before that committee, viz., the question of the treatment of periodic stock dividends.

A special committee on bankruptcy reform has been appointed to assist the authorities in Washington in the investigation of the operation of the bankruptcy laws ordered by President Hoover, who has indicated his appreciation of our offer of assistance. It is hoped, as a result of these efforts, that the accounting profession may be accorded greater recognition in the future administration of these bankruptcy laws.

During the past year the Institute has lost many men who had rendered outstanding service. Two in particular should be mentioned: Waldron H. Rand, a past president and long a member of the board of examiners, and the other, Lewis G. Fisher, former vice-president and a member of the executive committee and chairman of the committee on state legislation at the time of his death. These men rarely missed a meeting of the Institute and unhesitatingly answered any call to service.

There appears to be developing throughout the country, especially among the younger accountants, a deeper appreciation of what the Institute represents to the accounting profession. This is evidenced by an increased number of applications for member-

ship, by the interest expressed on the occasions when your officers have visited various parts of the country and by the letters received from time to time. This is, of course, as it should be if those guiding the policies of the Institute will ever keep foremost in their minds what is best for the profession as a whole and interest themselves in every worth while development affecting accountancy.

By the very nature of things most of the undertakings of the Institute will have to be effected through the voluntary coöperation of its members. I have been deeply gratified by the spirit of coöperation evidenced on the part of all to whom I have issued the call to service. To as great an extent as possible I have tried to enlist the services of the younger men, believing as I do that only by such enlistment can we hope to keep alive the spirit of the Institute handed down to us by those older practitioners who have given so much in the development of our profession.

I have been much interested in a recent study which developed the fact that in addition to past presidents the council now has in its membership only four men who were on the council when the Institute was formed fourteen years ago, and only two of those have served with slight interruption. The executive committee, as now constituted, has only two members who held any official position in the Institute as far back as 1916.

Another interesting fact is that in the membership roll of the Institute at the present time there are more than nine hundred firms of individual practitioners represented. I do not know how many individual firms are engaged in practice in the United States but I venture to say the Institute numbers a goodly percentage of the total in its membership.

These facts are mentioned not in a spirit of boasting but to indicate a reason perhaps for the increasing appreciation of what the Institute stands for and what it is trying to accomplish for the profession.

Important economic changes are taking place in the business world, and the accounting profession, because of its close relation to business, finds itself very much affected by these changes. I have felt very strongly during the past year that if we are to cope with the problems constantly arising and maintain the position we have gained for ourselves in the public esteem, we must maintain the high standards of ethics and practice developed over the past years.

Every effort should be made to extend the influence of the Institute by so conducting its affairs that every reputable practitioner will feel that he needs membership in order that his status in the community where he practises may be fixed. To accomplish this purpose the Institute should have the active coöperation of all its members so that its influence may be felt in every worth while movement. Its membership must so conduct itself that it will ever retain the respect of those interests we serve. I am more strongly of the opinion than ever before that we need just such an organization as The American Institute of Accountants.

Let me take this occasion to thank you who have honored me in this high office during the past two years, those members of committees who have worked so faithfully during the past year, members of the council who have, at much sacrifice of time and money, attended its sessions and to the staff in New York who have performed their duties efficiently and loyally.

The Accountant as a Profit Increaser as Well as a Profit Stater*

By J. P. JORDAN

The subject of this paper is "The accountant as a profit increaser as well as a profit stater." This subject was chosen on account of the fact that we are being forced in all our present-day business transactions to measure the effectiveness of every dollar spent in terms of what it is producing to help the business to be more successful, this success being usually rated in earnings.

There is not the slightest intention in any way to depreciate the necessity and value of stating profits correctly. On account of the fact that there are so many in this world who will deliberately mis-state facts, there has grown up a well warranted custom whereby certified public accountants should certify to the correct stating of profits, capital value, and everything else in connection with a complete set of statements of everything necessary properly to set forth the standing of any business institution. Anything said in this paper is not intended in any way to minimize the necessity of correct stating of profits and of the standing of a company as to its assets and liabilities. But, like everything else in this life, there is always something else that we can do to make ourselves bigger, broader and better, and it is what public accountants can do to make themselves more valuable that we shall discuss in this paper.

Doubtless many will say that a public accountant is not called upon to comment on organization, personnel, methods or anything of that sort. That might be so, because in most cases a client would not consider that he knew anything about it, and I guess in many such cases the client might be about right. It is for us, however, to discuss how this situation may be changed with profit not only to the clients, but much more so to public accountants themselves.

I want to review five points which, to my mind, have a very distinct bearing on the success of a business.

1. *Leadership.* No business can hope to be successful without proper leadership. I do not believe it necessary to discuss this point, as I think everyone will agree with this statement. But perhaps some of you may ask what leadership has to do with the

* A paper presented at the annual meeting of the American Institute of Accountants, Colorado Springs, September, 1930.

public accountant. My answer to this is that the accountant can have a lot to do with it. Admittedly an accountant who is a pure dyed-in-the-wool, non-reading figure merchant, will know nothing about what I am saying. But an accountant of the class which I believe is in the majority today is in a strategic position to know a good deal about the results accomplished by the chief executives of the company, on account of the contact which he has at stated intervals with men down the line in the organization. As a result of this he has a wonderful opportunity to judge how the leadership of the chief executives as well as the junior executives is succeeding in preserving and building up the morale of a company.

Furthermore, any outstanding public accountant invariably meets many executives who would, if they could, impose on the accountant a misrepresentation of the affairs of the company. I have known of many executives who have gone to the extreme of trying to induce the accountant to certify to figures to which no upstanding public accountant could possibly subscribe. Of course, outstanding cases of a flagrant nature are few and far between. But there are many cases where, in what might be termed minor situations, executives try to put across things which they should not attempt with a public accountant. In all such cases the public accountant has a wide open opportunity to preach business ethics, to argue with the executive that he can not afford to do such things; that any actions of proposed sort are bound to become boomerangs, even within the executive's own organization, with results which are bound in time to break down the morale. Of course, it takes tact and diplomacy to talk this way to such executives; but it is one of the opportunities for the public accountant to raise the standard of business, in general, and of any company which may have such executives at the top.

Executives of companies are quite justified in talking more confidentially with public accountants than they would perhaps wish to talk with anyone within their own organization. This is brought about by the fact that the public accountant is supposed to represent the *n*th degree of confidence. Furthermore, he is supposed to be in contact with so many businesses that it is natural for executives to talk with him about affairs of many different kinds and thereby obtain a range of thought which may be of value because the public accountant may have known similar circumstances of other companies and be able to contribute some

constructive suggestions. This alone is a field for the public accountant already recognized, a field which is limited only by the experience of the accountant himself. By this I mean that an accountant who is thinking beyond the figures themselves, who is studying all the various executives, department heads and everyone else with whom he comes in contact, who goes from one business to another and analyzes in his own mind why this business should do well while another is not doing so well, who studies the effect of the various accounting and control methods used by various companies, who in all ways is constantly searching for the *why* of the results, is the accountant who can be a most valuable consultant to the executives with whom he comes into contact.

An accountant who has studied the effects in various companies of different types of leadership can, with the confidence reposed in him by the executives who employ him, say to such executives many things that no one else can say. Therefore, there seems to be an almost unlimited opportunity for the public accountant to study and broaden his mind in matters of management as well as figures and thereby be able to carry to his clients a fund of experience and advice which will make him worth far more than he is worth as simply a stater of profits.

2. Organization. A good leader will invariably organize his forces in such a way that everybody will know what he is doing and what the other fellow is doing, thereby making certain that every possible thing is done to set up a proper, definite, organized procedure. Many problems enter into this question of organizing the personnel of a company. Engineering departments may be under one executive in one company and under an entirely different type of executive in another company. All the functions of a business, including manufacturing, purchasing, accounting, engineering, selling, traffic, personnel and all the rest of the functions, may be grouped differently with effective results. It is necessary in every business to determine how these functions should be grouped.

In many companies, especially those of some age, where individual men have grown up to large stature in the management of the company, we find organization grouped around these men instead of by functions. This is a dangerous situation as a function lives; but a person dies. Stability for the future, therefore, demands serious attention to the organization of the various functions and the fitting of the personnel thereto.

Here, again, you may ask where the public accountant comes in. I can answer quickly that he comes in to this problem as no one else can. His work as public accountant brings him in touch with the business to such an extent that he is in a position to know exactly what is going on, because he knows how all figures are grouped, and it is within his province to ascertain exactly what is meant by the groupings. As a result of this he is in a position to know how well the business is organized as to its functions and its personnel.

But here, again, comes the problem of the extent to which the accountant can go in remedying or suggesting remedies for conditions which are not healthy. My only answer to this is the answer which applies to anything and everything else, namely, the suggestion of remedies will depend entirely on the extent to which the public accountant has read, studied, analyzed, compared and in all other ways broadened his own mind concerning the conduct of business institutions in general as compared with a statement of how one institution has been conducted.

As the next of the five points we are considering intertwines somewhat with this matter of organization, let us pass on to the next point in order to have a freer discussion.

3. *Records to Fit Organization.* One of the gravest faults with records of any kind in the past has been the practice of having various expense, sales and other accounts, without a fixed responsibility within the organization for the results shown by the records. To get the best, not only out of the organization, but also out of the records, all records should be set up to fit the various responsibilities which have been definitely fixed by the organization procedure.

Nearly thirty years ago I started to play around with cost records. When I went into professional work in 1903, twenty-seven years ago, I called myself a cost engineer. Almost everybody called me a "nut." But it has always been my principal sport to do things which would bring out such a name. I shall never forget the first cost method that I installed. It was a "pippin." We had the direct labor all right—in fact, very well indeed; we had the material taken care of; and then we took everything else and added it by percentage to the direct labor and material combined. My recollection is that it took only about three months to find out how wrong that was, and then I started adding the burden in manufacturing to the direct labor alone.

From then on came rapid developments with which I have been occupied all the years since.

As we got along into 1910 and 1911, I began to wonder why it was that so many of the perfectly wonderful cost installations which I had put in fell by the wayside. Of course, each installation was perfect. Therefore, something must be wrong somewhere else. Accordingly, I began to make a review of some of the jobs to see what had happened. I found out two things: first, I found in a good many cases that somebody had better ideas about cost accounting than I had; second, and I believe this characterized the majority of cases, stating this with all due modesty, I found that the great trouble with the figures as set up was that they did not relate to any responsibility whatever, and therefore they were interesting to no one in particular and consequently next to useless.

This heading "fitting records to the organization" holds within it a remarkable secret. First of all, no man with a fixed responsibility cares to operate long without knowing how well his responsibility is carried out. Therefore, he demands records. Second, records fitted to these responsibilities give to the general management a fair and square control which means much to the management and to the responsible men in charge of the departments. Third, records built up in this manner are far more accurate than any group method or anything of that sort. Fourth, records set up to parallel and back up responsibilities open up a still more fertile field than anything mentioned yet,—which is covered in the next two points to be discussed.

Therefore, continuing our argument in respect to the relation of the accountant to the organization of duties, let me say that it is beyond my conception how any accountant can contribute much to proper record procedure unless he is thoroughly in touch with and contributes to the organization procedure. In other words, it seems impossible that proper records, other than the old fashioned merchandise account with a couple of expense accounts, can possibly be put into use unless the accountant first becomes acquainted with the organization, the departmentalization of all activities, and knows what it is that should be reflected in the records.

Records, when the accountant understands these things, become of real value. They become not only accurate, but a real control to the business. Such records are sought by the department

heads. The controller of a company with such records can be a real, vital helper to the men who are struggling with the business problems in manufacturing, engineering, selling and all the other departments.

It seems to me, therefore, that it is not only the opportunity but also the duty of the public accountant to go into all these matters and make himself of great value in transactions which in the past may have been considered beneath the public accountant's notice but are actually the factors of accounting that make or break a company. In this field the public accountant can contribute to the increasing of profits in a manner which he never in the world can do in simply checking up the vouchers, verifying accounts receivable, analyzing all the debits to capital accounts, and then certifying that he thinks the thing looks all right.

But even at that, we are only looking at the outside of the coconut; we have not as yet, except in leadership, got to the real milk.

4. *Standards of Performance.* If we are fortunate enough to have a good organization and if we are provided adequate records to back up this organization, we are now confronted with the question what we are going to do about it. The favorite custom of altogether too many accountants today is to compare this month's expenses of all kinds with last month's, and the year to date this year with the year to date last year, and all that kind of stuff. That may be wonderful from the standpoint of gratifying curiosity, but in the control of a business it falls short of the requirements.

In approaching this subject of standards I feel that I am going into a field in which public accountants have not taken advantage of their opportunities. And yet there may be a very good reason for that because setting standards requires an intimate knowledge of the minutest transactions in the company, in the manufacturing and selling departments particularly, and most of these problems are handled by the engineering group or by the sales analyst.

But there are two sides of the question. First, I will admit that the setting of standards—an all-inclusive term covering budgets, quotas, direct labor rates, and all things of that sort—is an operation which is far from the usual sphere of the public accountant. Second, there is a possibility that it has taken the public accountant a long time to study these things and to see the great advantages to be gained from the setting of standards.

Let us discuss this matter of standards in order to get a clearer conception of our purpose. Those of us who have been active in the analytical work called, if you please, "costs," found out quite a time ago that the laborious method of charging up to an order number everything that had to do with a certain job was positively ineffective. We found out, as the accountants themselves did years ago in the case of burdens where standard rates by percentage or by hour were used, that the same thing applied to the handling of direct labor and all the materials which entered into the product. Not long ago I was talking with some officers of a company which is still running job-order costs—and I know that they are not alone, there are many thousands of companies doing the same thing today. I asked this one question, "To what extent do you actually use the costs, after they are compiled, which purport to show the cost by operations, by material and by overhead of each run of each part?" Nobody could explain in a satisfactory way what use might be made of these costs except that they were averaged (and I want you to notice that word "averaged") to check their selling prices. In the control of the plant operations, they frankly admitted that when a cost was high they said it was on this account, and therefore would throw it out. When it was low, somebody had made a mistake. And so it would go. The net result was that no real use was made of the records of some thirty thousand open order numbers to which somebody was chalking up charges off and on.

At this point it may be well to mention that the old argument for job-order costs as being the basis of setting selling prices has long since gone into the discard. As far as setting selling prices is concerned, competition is doing that in the great majority of cases. Of course, we must have costs if we happen to be charging on a cost-plus basis, but other than that the one great use of cost figures today is for the control of operations, and this applies just as much to the staff departments and the sales department as it does to the manufacturing department.

Standard cost may be described as the cost that *should* prevail. Let us suppose that a concern is producing some piece on which there should be five operations. On the best type of machine, with the best type of tooling, and on the basis of time studied effort, these articles should cost exactly so much. Each article with a proper waste allowance should use just so much material. For a long time it has been considered that each hour applied to

the work should carry just so much overhead. Therefore, we can arrive at a carefully and scientifically studied figure as to just what any one article should cost. It may be a chemical which goes through various processes, or it may be flour which goes through its own peculiar processes, or it may be a textile which goes through all the processes from the raw cotton or silk to the finished product. Irrespective of what the product is, and nowadays irrespective of the quantity in which it is made, standards can and are being set.

Then, with standards set for the whole product we cut out a lot of the detail accounting, the thousands of cost cards, and we work an entirely different plan. Roughly speaking, the plan is to credit each department with the operations it performs, with the material it turns out, at the standard cost on which it is supposed to run, thereby arriving at a group credit against which we have the debits of the total payroll, the total material used in products and in expense items, together with everything else which goes into the expense, and out of this we get a comparison as to exactly how well any department, sales division or any other division of the business has operated as compared with how they should have operated.

Comparisons with the preceding year are certainly gratifying to curiosity. But things a year ago may have been so bad that anyone thinking that an improvement over such conditions is creditable as against a comparison with what they should have been as set up by scientifically figured standards is in a hopeless state. He will be left far behind the procession. There is not time to discuss further the matter of standards; but it is of advantage to remember that within the records which are provided to back up the various responsibilities there must be set up standards of what ought to be done, thereby furnishing each responsible head in the business with a means of control that can be obtained in no other way.

The comparison of actual departmental results, however, with what is allowed at these standards still leaves a vitally important factor, which is probably, except leadership, the greatest thing which has ever come into industrial management. This will be discussed under the next and last number of the five points.

5. *Extra Remuneration for Beating Standards.* One hears in business a great deal about loyalty. One hears of people with company spirit, esprit de corps, etc., and every one of these

elements must be continued. But the fact is that the time has gone by for waving a flag and saying, "Come on, boys," without some incentive other than honor and credit—both of which were often omitted when they could have been given without cost and at the proper time. Titles of "assistant" and "assistant to" and all such titles worked very well in place of a salary increase for many years, but since the cost of living has gone up to its present level, a title does not buy very much in the open market.

Men who have worked their heads off for the success of their companies have suffered many disappointments either through the deliberate failure of management to give them proper recognition in the form of a salary increase or through not knowing who has been really responsible for outstanding results. Therefore, business has become ripe for the institution of some means of extra remuneration which is not only safe for the company but gives each responsible individual employee an opportunity to increase his own income by a share of profits from betterments which he and his organization can effect.

This brought into being incentive methods of extra remuneration. These methods have taken many forms. At present the principal form is probably some kind of profit sharing. Or it may be some form of stock purchase on advantageous terms. One of the most recent and effective methods is "savings sharing" whereby each responsible head may share in the savings over a fixed sum. Savings sharing does not mean just saving money. It may mean spending more money. It does mean spending less money per resultant performance. That is, if \$1,000 is supposed to design, or manufacture, or sell 1,000 units of performance, and 1,300 units of performance result at a cost of \$1,100, a saving of \$200 is made. Or, if 1,000 units of performance result for a cost of \$900 a saving of \$100 is made.

A standard or bogey, or whatever you like to call it, is set up for each measurable unit of every department. Actual performance is measured by the standard, and a saving or loss results. This I shall regard as sufficient to describe "savings sharing" for the purposes of this paper, as it is not my intention to submit a definite set of specifications for installing such a method.

Savings sharing is superior to profit sharing in that it is applied directly to each definite division which is measurable. What the over-all profit may be means nothing to most "key" men below the chief executives. Even if it did mean anything, what could

they do about it more than operate their own departments in a manner to beat their own standards, and thus in their own departments contribute their share to the general result?

It is my theory that every "key" man should receive a salary sufficient to cover his living, with a little allowance for extras but no allowance for what might be called the accumulation of wealth. It does not seem reasonable to expect "key" men to accept salaries which will not guarantee peace of mind, irrespective of business conditions, but it does seem reasonable, and it has worked effectively, for "key" men to take a chance on their wealth accumulation by being permitted to participate in a plan whereby super-effort will result in much larger income. These salaries might be termed the equivalent of a normal return to the stock-holders of say 6% or 7% on their invested capital. From then on the stock-holders may well afford to give to the "key" men a reasonable share of results which are better than the normal results which should be returned for simply a straight salary remuneration.

Most of this might better be on the basis of savings sharing, but certainly part of it should be on the basis of profit sharing, particularly in the case of the higher executives who are responsible for the over-all results.

It is probably obvious that the standards mentioned become the ideal basis for the setting up of savings-sharing plans, with the general profit and loss of the company as the basis of the profit sharing.

And now again we find a fertile field for the accountant, at least the accountant who has the inclination to become a real factor in counselling methods of management which will increase profits rather than simply state profits.

It is perfectly true that the most forward reaching work in this matter of incentives has probably been developed by persons and groups other than accountants. It is quite natural that this would be the case, particularly when groups other than public accountants have contributed so heavily to the development of standard costs and standards of all sorts in all departments.

But this has no bearing whatever on the point that public accountants should use every effort to know and understand all the intricacies of up-to-date and effective incentive methods. It is not enough for anyone, a public accountant, an engineer or any other kind of a practitioner, simply to get a few smattering ideas in respect to these methods and run the risk of destroying his own

reputation by finding that he is giving counsel which may be far behind the times when he is giving it. Improvements in incentive methods and the use of standards are coming along so rapidly that it is difficult for anyone not directly concerned in that particular kind of work to keep up with the latest practice. There are two ways, then, for accountants to go. One is to study and follow these methods carefully, and the other is to enter into the research and development of these methods and so become of greater usefulness to the clients they serve.

But here again one may say, "What has the public accountant to do with these detail methods?" My answer to such an inquiry is that there is no money to be made or lost in simply stating profits. The money is made or lost down in the firing line where we find the actual disbursers of the money. We may have so-called disbursing officers, we may have controllers, we may have accountants, we may have a whole array of such officers, but the foreman who is handling the men who are producing the goods is much more the actual disbursing officer than anyone else in the upper strata of the organization.

This whole question of becoming a profit increaser rather than simply a profit stater is wholly within the jurisdiction of each individual public accountant. It is obvious that any man in any walk of life who does constructive work whereby a company may produce better results is worth infinitely more to business than a man who is a pure, out and out checker of what somebody else does. Again I wish to say that I am not in any way minimizing the importance of the verification of transactions. But I do say that there is nothing to be accomplished in the boneyard or after all the meat has been picked off. This expression has been used by many executives. If I may bring you any message today that is worth while it is this: Business needs constructive thinking. Business needs men who are thinking in terms of better conditions. Business needs men to take hold of companies so as to reduce costs, to better the morale of the personnel, to build up men to have a greater interest in the work they are doing, with the result that the future of American business shall be greater in productive value than at any previous time.

We have been going through and are still in troublous times. Business is slack. The wave of prosperity has broken for the time being. Most executives, spurred on by carping boards of directors, have ceased the expenditure of money even against good

judgment. There are many constructive things which might be going on at this moment, and yet retrenchment programmes have been carried so that, when business does change, many companies will wish they had taken advantage of the lull to repair their fences, to start up new ideas, and in all ways to be set to go when business starts to return. Many executives cut off here, and cut off there, and cut off everywhere, with no thought for what it will all mean in preparing for the next run of good business. American business has shown for years that it can not be checked permanently. Confidence is unquestionably returning, and as soon as we begin to pick up speed the opportunities for constructive work will come thick and fast.

How does the public accountant regard all these constructive ideas? He has a strategic opportunity to contribute heavily. In his unique position to the management he can talk leadership, organization, records, standards and incentives. All five of these points are extremely important in the setting up of a psychological picture which will be almost irresistible. Think what it would mean if every qualified public accountant in America were fully qualified to advise, if not act, on all these constructive ideas. Think how many weak-kneed executives could be put on their feet; think how many spineless boards of directors could be urged on by advice, counsel or big-stick methods into permitting or perhaps forcing the management of their companies to get up to the line and not remain back with the also-rans.

No one in this whole country is in as good a position as the public accountant to wield a most beneficial influence on the executives of all of our big and small companies. And yet I am frank enough to say that I know personally scores of public accountants who are so out of date and so far behind in their knowledge of things which are absolutely vital to industry that they are nothing much more than high grade clerks. Honest? Most assuredly. Constructive? No—far from it.

Accounting Practice In England and America*

BY HAROLD R. CAFFYN

I need hardly say how much I appreciate the invitation extended to me to address this of all gatherings of accountants in this country upon a subject which has been of tremendous interest to me during my five or six years of public practice here. Nothing, perhaps, has impressed me more than the openmindedness of the people here, their desire to hear of and their ability to benefit from the experiences of others. It is with these qualities in mind that I address you, well knowing that if I speak of matters on which I think something could be learned from English practice rather than of those on which this country is undoubtedly ahead, you will not accuse me of prejudice but rather of a desire to furnish you with what I think will interest you most.

First it must be understood that public accounting in Great Britain is accepted without question as one of the leading professions and enjoys a prestige similar to that attaching, for instance, to the law, the church and medicine. Those engaged in it consist of three principal classes: first, the so-called qualified men, sometimes employees but generally employers; second, clerks articled to qualified men and non-articled clerks in the offices of qualified men.

Although other bodies do exist, I might safely say that for practical purposes all qualified men are members of one or two bodies: the Institute of Chartered Accountants, founded by royal charter in 1880 and having approximately 9,000 members, and the Society of Incorporated Accountants and Auditors, a body registered under the companies act in 1885 and having approximately 5,000 members. The customary degree in these bodies is termed associateship while a further degree of fellowship is available to those who have been in practice for themselves in Great Britain for more than a certain number of years.

Admission into these bodies can only be obtained by articled clerks, with the exception that a man who has been in public practice for ten years may sit for the Incorporated examinations. Each member in practice for himself or in a partnership is per-

*A paper presented at the annual meeting of the American Institute of Accountants, Colorado Springs, September, 1930.

mitted to have two articulated clerks. These articulated clerks are frequently the sons of personal friends or of clients. They are, generally speaking, men of the most desirable type from the professional viewpoint.

Articles consist of a contract between employer and clerk. This contract is of five years' duration, although college graduates may obtain three-year articles. The articles provide that the clerk shall serve his principal and the principal will assist the clerk in providing practical experience and instruction. There may be charged for these articles a premium up to \$3,000, of which, generally, about two-thirds is returned during the five years in the form of a nominal salary. On the other hand, a firm wishing to retain a valuable man for five years will sometimes give him articles and pay him his regular salary. Articled clerks frequently go through a month or so of probationary service in order that their principals may obtain some idea as to their desirability.

The organizations sponsor students' societies to assist articulated clerks in their studies. These societies provide quiet rooms for study, coaching courses at extremely reasonable rates and other facilities for students.

There are three examinations to be passed: first, the preliminary, purely scholastic and a prerequisite to articles; second, the intermediate, taken not less than half way through one's articles but before their termination; third, the final, taken at the conclusion of one's articles.

Progress in the office is considerably slower than it is here, and, although the articulated clerk is sometimes a senior by the time he has passed his final, the non-articled man might easily work fifteen years to attain this status. He might, of course, never attain it.

It is perhaps nationally characteristic that the work should be more detailed and that a greater sense of discipline should exist throughout the office than here.

The work itself can be divided into the following main groups:

1. Statutory audits of limited companies
2. Other audits and examinations of limited companies
3. Audits and examinations of partnerships and individual traders
4. Bankruptcies, liquidations and receiverships
5. Estates and trusts

6. Income tax
7. Costing
8. Secretarial work

Much of the work is similar to that here, but certain phases of it require further comment.

The rapid development of mass production in this country has naturally led to a correspondingly rapid development in costing. Recent years, however, have seen a similar development in England and a gradual specializing by certain accountants resulting in the formation of a specialized body—The Institute of Cost and Works Accountants.

Many companies in England use their accountant's office as their registered address. The accountants in these cases frequently have a partner or one of their employees named as secretary, board meetings are held at their office, corporate records are kept there and, in some cases, stock transfers are registered and dividends paid from there. In other cases all the records, corporate and financial, are managed.

Another phase of work of which little is seen here comes largely through the recognition of the profession there. It is quite customary for accountants to be appointed by the courts or by deed as trustees, administrators, executors, liquidators, receivers and managers.

Apart from the above-mentioned differences, however, there is one of even greater significance: it is the statutory audit of limited companies. The statutory audit forms the principal part of the public accountant's practice. It is not a balance-sheet audit but a complete examination and arises through the provisions of the companies act. This act provides that every limited company shall hold at least one general meeting in each calendar year, at which the accounts for the preceding fiscal year are presented. These accounts must be signed by two directors and must contain the auditor's report. This report must be read before the shareholders at the meeting. The act defines the auditor's duties in the broadest possible terms, and the provisions in this respect have, through practice, become incorporated in a form of certificate which, with minor variations, has become practically standard. The usual form of this certificate is as follows:

Report of the auditor to the shareholders of the (Blank) Corporation. We have examined the above balance-sheet and

accompanying profit-and-loss account of the (Blank) Corporation for the year ended . . . and have obtained all the information and explanations we have required. In our opinion, such balance-sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company.

You will notice that this report is addressed to the shareholders. This arises from the fact that the auditor is appointed, not by the officers at all, but by the shareholders at the annual general meeting and he is auditing purely in their interests.

Strength is given to the auditor by virtue of the fact that the above certificate has become so well known and recognized in the commercial world. It is a valuable check on the directors, for any qualification of it is calculated to assure a most inquisitive and potentially critical attendance at the annual meeting. Even further strength is given to the auditor by the fact that any proposed change in auditors must be the subject of special notice to the shareholders of the meeting at which the change is to be proposed.

Comparing the actual audit with that here, I think I could best describe it as synthetic rather than analytical. Books of original entry are checked in considerable detail and worked into the ledgers and statements, and there is, accordingly, not so much need for an analysis of figures submitted. I can not help feeling that this is far less inspiring to the auditor, more likely to become mechanical and less likely to develop the intelligent use of one's head and business experience than the method generally followed in this country.

The statutory auditor usually signs the customary certificate. He seldom volunteers any comment on the operating results or financial condition of the company. Here, I think, the English client loses one of the most valuable services rendered by accountants, for I have been particularly impressed with the broad reviews which many accountants render to their clients here. These reviews are occasionally rendered in Great Britain but are usually the result of specially arranged assignments.

Tax returns are rendered throughout the year and for this reason the accountant's work is far less seasonal than here.

The facts that fewer mechanical devices are used and papers sometimes filed in dusty old tin boxes are minor differences.

Reminiscent of the Dickensian age, too, is the fact that all members of the staff in my firm were supposed to wear high hats and that our reports were, until a few years ago, handwritten. One of these old customs, however, that of afternoon tea, I really can commend to you, even if only for the purpose of obtaining a little company myself.

Billing is largely on a per-diem basis, although there is perhaps rather more tendency to charge a fee for work performed. As I recollect it, rates are approximately as follows:

Seniors.....	3	guineas, about	\$15.00	a day
Semi-seniors.....	2	"	"	10.00
Juniors.....	1½	"	"	7.50

When the difference in monetary value is taken into consideration it will be realized that these rates differ little from those prevailing here.

There is little outstanding professional legislation which I consider of interest for this paper. The chartered and incorporated accountants coöperate very harmoniously in professional development and their advantage over other bodies is best evidenced by the fact that shareholders seldom appoint accountants outside their ranks as statutory auditors, although no specific bar to others exists. There has been considerable discussion during recent years as to the desirability of effecting legal registration of qualified practitioners and the exclusion from practice of those not registered.

Now that I have given an all too brief outline of the conditions prevailing in England, let us go back and conclude with a consideration of those from which something might be learned here.

First, the students' society. I think that an institute, developing the way ours has, could do quite a lot to maintain the students' interest in it by the sponsorship of a society similar to the students' society in England, which could, perhaps, under the guise of rendering technical assistance in study, actually develop a trend towards professional sentiment and loyalty to the profession at large and to this Institute in particular. This applies especially now that the Institute is doing so much to develop interest in its activities on the part of the more promising products of the colleges here. Through such a society young men, fresh from college, could catch a glimpse of the sound professional de-

velopment which is taking place and would automatically spread this knowledge to their younger friends still at college.

The question of office organization is also one on which I think something might be accomplished. The usual arrangement existing in England has proved to be a satisfactory one there, and I will briefly outline it. We will assume a firm of medium size, having five partners, each dealing principally with the work that he himself brings in, but turning some of this over to his partners. Under these partners will be possibly seven or eight seniors. Each of these men will generally cover work assigned to them by all of the partners, but, of course, a senior may tend to become attached more to the work of one partner than another. Below these seniors will be, say, sixteen or eighteen semi-seniors. Now, these semi-seniors are quite definitely allocated to a certain senior. Similarly the twenty-five or thirty juniors will be definitely allocated to specific semi-seniors.

As a valuable addition to this system I have seen a plan in operation under which the seniors held a monthly meeting for the purpose of discussing the status of their assignments, the relief of overworked men, office problems and the work of the junior members of the staff. The advantages of this system, as I see them, are as follows:

1. There is a continuous process of education going on throughout the office, the senior, himself educated by five partners, teaching his semi-seniors to do their work and submit their working papers in the form which he himself has learned to be most fitted for the task and the office, and, of course, the semi-senior in turn educating the junior in a similar way and finding any time so spent amply repaid.

2. There is a flexibility in the handling of men. Semi-seniors and juniors are lent from senior to senior without having to worry the partners with organizational details which they are so frequently incapable of handling through lack of knowledge of the junior men concerned. Moreover, should a semi-senior or senior be taken sick there is always a man available who knows practically as much about the work involved as the sick man did and who can step into his shoes with little extra supervision.

3. The clients are not being worried continuously educating new men, but, at the same time, there is no tendency for staleness to develop on the part of the auditor, since there is an automatic steady progression throughout the office.

4. By grading the men quite definitely there is something for them to aim at and a ready means of recognition of their ability is available.

5. Particularly where the seniors' committee is utilized, I think that much is gained in that the seniors think rather more in terms of the firm and less personally. I think, moreover, that it is most valuable to have a committee that can bring to the partners' attention any minor grievances or suggestions for improvements in the firm's policy, the discussion of which may be to its best interests.

The statutory audit, bankruptcies, liquidations, trusts and similar work will probably come to accountants in time in this country as the profession develops standing in the lay mind; and this thought of professional development brings me to the question that interests me most in a comparison of practice in the two countries.

Let us consider for a minute what we are really looking for in our profession. I think if I have been able to paint the picture I have wanted to paint of the profession in England, that picture would be readily reconcilable with one of the profession as you would like to see it here.

The professional accountant there is essentially a man of good type, one who can meet his clients at least as an equal and who enjoys their personal respect and confidence. His advice is considered sound, trustworthy and conservative and his signature is regarded as the hall-mark of correctness and integrity. Above all, these qualities attach to him in the eyes of the public and the business world, and it has been of interest to note how many chartered accountants are now offered seats on the boards of the principal companies purely for the stability and prestige which will accrue from their inclusion.

To this situation I think four main factors contribute:

1. The standard of the accountant's work is of high quality.
2. The profession is disciplined.
3. The profession is composed of men of the right type.
4. The business public has learned to associate these qualities with men having the degrees of certain bodies.

The second of these, discipline, is a minor factor and arises out of the others. The education of the business public, too, grows automatically as certain bodies adopt and let it be known that

they have adopted the two principal factors—standard of work and type of man. These, it seems to me, are the very keystones of any profession.

So far as the standard of work is concerned, I believe the better accountants here give their clients as much, if not more, than those in England, and I can not avoid the conclusion that the tremendous difference between the standing of the profession here and there arises almost entirely from the third factor I have named—the type of man. Let me make it quite clear that I am talking of the profession at large here and quite definitely not of this Institute.

This Institute has, undoubtedly, the right type of membership and, left as it is at present and with, I think, the use of some short title by which its members might be more readily recognizable to the public, I do not see how it can fail to do all that the chartered accountants have done in England. One thing stands in its way, however. As it develops prestige its membership will become more valued and as it does so, nothing at present in its by-laws can prevent the invasion of its ranks by people capable of meeting its requirements and passing its examinations but devoid of the personal qualities so necessary in the profession. These must eventually bring it into disrepute. In other words, its increasing strength will invite increasing weakness.

I think it is essential that, if you are to make this body the standard bearer of the profession, you must sooner or later consider not only your applicant's technical qualifications, not only his ability to pass your examinations, but also, perhaps above all, his desirability and suitability as a member of this fine profession.

Let us look for a moment at a few of the qualities we are seeking. I do not think any of you will dispute the need for the following:

1. Good sound education, not only practical, but also academic—not only that obtained scholastically, but, more important still, that obtained through environment, either in a good home or amongst a sound circle of friends.
2. Breadth and clarity of vision.
3. Individuality in thought, not, of course, to the extent of eccentricity, but rather coupled with and balanced by our next quality—conservatism.

4. Conservatism not only in thought, but also in such matters as speech and dress.

5. Personal likability. While I agree that you could not exclude a man for lack of this quality, its presence adds tremendously to his professional value.

6. Patience and good temper. I do not need to explain to any of you what exercise these two get in the profession.

7. High mindedness and moral purpose.

8. Sincerity.

I could add more, but will, instead, refer you to your own colleges where you will find fine young men endowed with these qualities and others. If only we can make the profession and the Institute sufficiently attractive to these, we need have no fears for its future.

You will next ask, perhaps, "By what method is this desirability to be measured?" Examination of type by personal interview would be manifestly unfair and inconclusive. Recommendation solely by persons outside the profession would be equally unsatisfactory. A monetary distinction would be unthinkable.

I am going, later on, to suggest a plan. Its aim is to provide a method for appraising a man's desirability through sponsorship by existing members. In some of its features it does resemble the article system, but since I know that to many of you that system does imply a monetary distinction, I have purposely refrained from using that term.

I am sure that it is no coincidence that those bodies in Great Britain which do have this article system really represent, not only ours, but most other professions there, and I feel convinced that the method she has learned to be the best in the development of her professions must follow here eventually in substantially the same form. None of the professions here appears to have the standing it should enjoy, and I do not see any reason why ours should not show the way. I do see every reason why the American Institute should lead our profession, for its ideals and the men behind it are fundamentally sound.

Please do not think that what I am about to propose is any hurried suggestion. It is the result of much thought and many interesting talks on the subject. It should not be dismissed as something all very well for England but impracticable here, for I

have modified it to meet conditions here even as my own insular ideas have been modified and broadened by my experiences in this country.

Do you not think the adoption of a plan and rules similar to the following would achieve the effect I have outlined?

1. Admission into the Institute after some future fixed date to be restricted to members' clerks registered as such at the Institute.
2. Each practising member of the Institute to be allowed, say, two registered clerks.
3. In order not to restrict growth to too great an extent it might be advisable to permit members of the Institute, not in practice for themselves but employed by other members of the Institute, to have, say, one registered clerk.
4. No person to be registered who shall not have a preliminary education of a standard acceptable to the Institute.
5. Registration to be for a period of five years, with the possible provision that a college graduate of recognized standing should be permitted a three-year registration period and I might even suggest that a man bearing a certified public accountant's degree of acceptable standard be permitted a one-year registration.
6. No registered clerk to be admitted without a certificate from the member to whom he has been registered as to the adequacy of his experience and his fitness for the profession.
7. Holders of acceptable C. P. A. degrees, at the date of inauguration of the system, to be permitted to apply for membership within, say, one year, but their applications to be sponsored by two members of the Institute.
8. Persons who shall have been engaged in public accounting for, say, ten years, to be permitted to sit for the examinations and obtain membership provided that they obtain the sponsorship of, say, two or three members of the Institute, that at least a fixed amount of their experience shall have been gained with members of the Institute and that they shall be employed with members at the time of their application.
9. A record to be kept of members to whom clerks are registered and by whom applicants are sponsored, and against these members to be recorded any unprofessional or unethical acts on the part of those so sponsored either before or after these men become members of the Institute. If more than a certain number of counts are registered against any member, that member to be denied the privileges of having registered clerks and

sponsoring applicants. Further disciplinary penalties might, of course, be imposed.

At this point I want to explain how the misconception arises which leads to the linking of the article system and a monetary distinction. When the article system was originally introduced in England it was somewhat similar to the above. The payment of premiums and the service without remuneration developed purely through the operation of the law of supply and demand, and are the strongest possible indications of the success that the system met with in its attempt to make its membership desirable. Should it meet with similar success here, and I see every reason why it should, your national disinclination to have this apparent monetary distinction could always be satisfied by the Institute through an increase in the number of registered men allowed each member.

Here are some of the advantages which I can see accruing from the adoption of such a plan, of which I have, of course, given only the broadest outline:

1. The automatic restriction of membership will attract acceptable C. P. A.'s and thus strengthen the Institute with members of the right type.
2. Registrations and sponsorships will become increasingly valuable, and as they do the existing members of the Institute will be more and more able to choose the men whom they are accepting as future members of their profession.
3. Careful selection will be forced upon the members of the Institute owing to the provision under which the privileges of registration and sponsorship may be curtailed.
4. The Institute will, as its degree becomes more valuable, develop more and more discipline over its members through its ability to suspend them for unethical conduct.
5. Perhaps one of the greatest advantages would be that arising outside the profession as the adoption of this scheme became known. It could not fail to impress bankers and the more conservative clients with whom we work and would, I believe, be a tremendous factor in the development of such steps as the statutory audit were it known that a body existed which had the disciplinary control which the exclusiveness of its membership would confer upon it. Incidentally, I see no reason why the Institute should not embark on a very

definite policy of advertising in its members' behalf in conjunction with the plan outlined.

6. From the practitioner's point of view, quite apart from the additional prestige he would acquire, it would be of great value to have on his staff men who would give tone to office and who would spread the high professional idea.
7. From the student's point of view there is everything to be gained. He gets a practical training which no amount of money could purchase at any business college. In addition, he knows that when he has worked and finally qualified, the degree he has will have a definite standing and will improve rather than diminish in value. The plan and all it offers to the student could be used as excellent material by those officers of the Institute who visit the colleges to obtain potential members. It could not fail to appeal to those now at college who see all the old avenues—real estate, bonds, insurance, etc.—hopelessly overcrowded and overrated, and who are looking for something more stable as a career.
8. The man who becomes a registered clerk immediately feels that he has entered a profession and begins to develop a professional spirit and outlook. This, I think, will have the same advantage as that accruing through the students' society in that these men, fresh from college, will gradually disseminate the professional idea through their friends still there.

I have, as I have stated before, given only an outline of what I think might be done here. Minor flaws may be apparent to some of you, but I feel confident that these could be eliminated and that there is everything to be gained from the adoption of such a plan.

I feel that, even should this particular solution not appeal to you, the Institute's and the profession's futures do deserve the most serious, broad-minded and far-sighted consideration, and that the time is opportune for the appointment of a small but energetic committee to take this far-sighted view in an intensive study of professional conditions, practices and trends not only in this country but in those that have had perhaps longer, if not more, experience than we have here.

Professional Ethics and Modern Business Tendencies*

BY WILLIAM B. FRANKE

It will be conceded, I believe, that the ethics of a profession are greatly affected by the growth of that profession. When only a few persons are engaged in the practice of a particular professional calling the possibilities of encroachment one upon another are slight. In a profession such as ours, however, in which the number of persons engaged is already considerable and is constantly increasing, and in which the scope of activity is ever broadening, it is desirable to consider at periodic intervals whether our rules of conduct, which have been formulated at some prior date, are still satisfactory.

If rules of professional conduct are to be satisfactory it must be evident to each person who follows them that they produce satisfactory results. In measuring these results not only must the financial return be considered but also the happiness and contentment derived by the individual practitioner through the conduct of his practice in an ethical manner. If through the observance of a code of ethics members of a profession achieve these results, then that code may be considered not only satisfactory but practical. It is, therefore, from the standpoint of practicability as opposed to theory, and in the light of present day conditions, that I submit for your consideration my comments on the rules of professional conduct which have been adopted by this Institute.

There are twelve rules of conduct in effect at this time, including amendments declared effective May 16, 1929.

The first rule relates to the use by a firm or partnership of the description "Members of the American Institute of Accountants," and restricts the use of this caption to partnerships all of whose members are either members or associates of the Institute. It requires no comment.

The second rule provides for the expulsion or discipline of a member who either wilfully, or as the result of inexcusable gross negligence, certifies to statements containing essential misstatements of facts or omissions tantamount thereto. This is, of course, a thoroughly practical rule and one which will always be modern.

*A paper presented at the annual meeting of the American Institute of Accountants, Colorado Springs, September, 1930.

Rule number three states that no member or associate shall allow any person to practise in his name as a public accountant who is not a member or an associate of the Institute or in partnership with him or in his employ on a salary. I had never heard of a case where an accountant permitted another accountant not in partnership with him or in his employ to use his name until a few years ago. A young accountant, not a member of the Institute, came into the office one day to ask for a position on our staff. He told me that he had been engaged in practice on his own account in a small town not far distant, but because of circumstances surrounding his practice he had decided that it would be preferable to give it up and obtain a position as a staff member in another firm. The circumstances to which he referred were these. He had been reared in this same small town, had taken an accountancy course after graduation from high school, and had had two years' experience with a small public accounting firm. Through family friends he was assured of a small amount of work if he opened an office for himself. However, the more important work in town he felt he could not obtain without more prestige than his own name would give. Feeling the need of advice he obtained an interview with a partner in a fairly well-known firm in a large city. Much to his surprise this partner suggested an arrangement whereby the young accountant would be permitted to use the name of the firm and its stationery. He would be allowed to sign the firm name to letters and reports without any supervision of his work or approval of his reports by the firm. The only stipulation was that he should pay a percentage of his gross fees to the firm. Fortunately for the young accountant, when he had practised for a few months under the plan, he realized that it was dangerous for both parties and decided to give it up. In a case such as this the necessity for the Institute rule is obvious. Had the young accountant made a serious mistake, as he well might have done, and had the firm he represented been composed of members of the Institute, as it was, harm would have been done to the Institute and to the whole profession.

Rule number four forbids the giving or accepting of commissions or other participation to or from the laity. This rule prevents, for example, the giving of commissions to outsiders for engagements obtained through them, and the accepting of commissions from stationers and promoters for business turned over to them as an incident of services to clients. It seems unneces-

sary to discuss this rule at any great length. A professional man who would give his best services must be absolutely uninfluenced by external matters. This necessary state of mind can not be induced if an accountant depends to any extent upon the purchase of a certain number of the engagements which he performs or if he is forever considering ways and means of making money through his clients other than as a return for professional service. Furthermore, of course, the feeling of a client toward an accountant who engages in this sort of thing, if the client finds out about it, is apt not to be a particularly friendly one. The client may feel that perhaps he could have gotten better stationery at a lower price or have sold more bonds or stock at a lower underwriting cost. It is probable that he will feel that much more favorable results would have been produced had the accountant not been financially interested. A few days ago, during the course of a conversation with a manufacturer of pharmaceutical preparations, I learned somewhat to my surprise that most of the sales of this manufacturers' products, which are not widely advertised, are made through physicians who prescribe them and receive monthly commissions based upon the sales value of prescriptions written, the reports of prescriptions being transmitted to the manufacturer through designated pharmacists in particular cities. Such an arrangement is a violation of medical ethics, and the reason is obvious. If my physician prescribed one of these preparations and I learned that in addition to the fee he charged me he was receiving a commission on the sales value of the prescription, I would feel that perhaps the commission might have prejudiced his prescription for the cure of my particular illness. This illustration is similar to that of an accountant having an arrangement with a stationer.

The fifth rule provides that no member or associate shall engage in any business or occupation conjointly with that of a public accountant which is incompatible or inconsistent therewith. I presume that cases have arisen which have made this rule necessary. Most of the accountants I know, however, have had to work so hard at their profession that they could not possibly have found time to indulge in any other sort of work.

Rule number six prohibits the certification of work which has not been verified by the accountant himself, a member of his firm, one of his staff, a member or an associate of the Institute, or a member of a similar association of good standing in a foreign

country, which has been approved by the council. This of course is a basic rule and one about which there can be no argument. Unfortunately the observance of this rule does not guarantee that all work turned out will be satisfactory. The profession has grown so rapidly in the last few years and it has been so difficult to obtain competent men that in some instances men have been employed to supervise engagements who were not competent to exercise such supervision. This is, of course, the danger which arises in an expanding practice. It is because of this danger that one excellent accountant whom I know has limited his business so that he may be assured of proper supervision of the work turned out by his office.

Rule number seven requires that a member or an associate who shall in any way attempt to secure the amendment or enactment of laws affecting the practice of the profession shall give notice thereof to the Institute. This rule may require a lot of letter writing if you live in New York state and make an annual effort to change the New York state C. P. A. law, but nevertheless it is a good rule.

Now we come to rule number eight. This rule reads as follows: "No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice."

What controversy this rule has caused! Writing a paper of any sort is educational. For example, I never before knew that the prescribed ethics of the Institute do not forbid the solicitation of business where no member of the Institute is already on the job. I am somewhat curious to know just how one goes about soliciting the business of a prospective client, bearing in mind the wording of rule number eight. I can picture the solicitor gaining admission to the office of the hoped-for new client. But then what does he do? Is his first inquiry, "Who are your present accountants, if any?" If there are any and he is told the name of the firm does he then turn his back and hastily thumb through the pages of the last Institute year-book in order to find out if the partners of the firm are members of the Institute? If they are I presume he makes a polite excuse and leaves—providing he follows rule eight. If they are not, then I suppose he goes ahead with his sales talk and tries to take the business away from the firm regardless of how competent it may be. Supposing that he

secures the engagement in these circumstances, imagine how horrified he would be if upon returning to his office he found that the partners of the firm he has displaced were elected to membership since the publication of the last year-book. One should be careful about these things. Actually I am afraid that if a member decides to solicit and gets as far as an interview he casts ethics to the four winds and forgets that there is such a thing.

It seems to me that it is about time that we fell in line with the older professions and barred all kinds of soliciting to the members of this association. Personally I am of the firm opinion that, in the first place, not enough business is secured through solicitation to warrant the expense, and in the second place the kind of business which results from solicitation is apt to be quite undesirable. I have in mind the experience of two exceptionally well-qualified young men who started to practise accounting at about the same time. The first man decided that there was only one way to get business and that was to go after it. Accordingly he plotted the city into sections and started out on a sort of store-to-store and office-to-office canvass. In the course of three years he had secured perhaps a half-dozen monthly clients at from \$10.00 to \$25.00 a month a client. At the end of the three years, however, he was tired out, soliciting being hard work for the accounting personality, and had practically nothing to show for his efforts. He finally gave up his small practice and took a corporation position at which he has done extremely well. The other accountant opened an office in a smaller city at the request of a bank, which incidentally never gave him any business after he had opened his office. He did no soliciting whatsoever but spent his time in becoming acquainted with the people of the community in a perfectly ethical and proper manner. It was rather hard sailing for a time but it was not long before he found that business was beginning to come into his office. Not being required to solicit he was able to give his full thought and attention to the few jobs which he had with the result that his work was so well done that in many instances new jobs came from old ones. At the end of his three-year period he was well known in his city and had the beginnings of a lucrative practice. Now, of course, I realize that some people may say that the second man solicited business in an indirect manner by making acquaintances which he felt might be good for his business. The fallacy in that statement is that any work which came to him came voluntarily, which placed him in a

far different position from that of the first man who went out after the business he got. A solicited engagement places an accountant in a queer position to the client. The client is very apt to feel that he has employed the accountant just as he would employ a bookkeeper, and, therefore, that he is entitled to dictate the manner in which the accountant shall perform his work and the sort of report he shall render.

I believe that the solicitation of accounting work is in the long run a tremendous handicap for the reason that it puts the accountant who indulges in such a practice into a class from which he never escapes. Using as an illustration another profession, if you knew that a lawyer were in the habit of obtaining his business through solicitation you certainly would not engage him as your attorney if you required legal service. The same thing is true of the accountancy profession. If you obtain a reputation of soliciting business the desirable men in the community, who intuitively dislike such a manner of securing business, will engage a practitioner who avoids solicitation.

I hope that the members of this Institute will soon realize that we have reached the point where we can not afford to differ from the older professions in points of basic professional ethics and will agree that solicitation of business whether from prospective clients who employ members of the Institute, or those who employ accountants who are not members of the Institute, or those who have no accountants whatsoever, should be barred.

Rule number nine provides that an Institute member or associate shall not take away the employee of another member or associate unless the initiative is on the part of such employee. This requires no discussion.

Rule number ten relates to professional fees and states that no member or associate shall render or offer to render professional services, the fee for which shall be contingent upon his findings and the results thereof. I have often wondered why an accountant should offer to render services upon the contingent-fee basis. It seems to me a thoroughly unpractical method of practising a profession unless an accountant has so little to do that he can afford to devote his time to work which, if it produces nothing, will not put him in a worse position than before. If it is this sort of accountant who does contingent-fee work then, of course, the prospective client, if he realizes that fact, is unwise in employing him upon such a basis because of the quality of service which he

probably will render. Most contingent fees, of course, relate to tax work, and since this is not of such importance these days as it used to be, the question of contingent fees is correspondingly less important.

Rule number eleven is the longest of all the rules prescribed, and, in my opinion all of the space which it takes up is wasted. It states first that no member or associate shall advertise through the mails, in the public prints or otherwise, except by the publication in the public prints of what is technically known as a "card." The definition of such a card is next given in minute detail, following which are given the sizes of the cards permitted for newspapers, magazines, directories and similar publications.

It is my experience that the hope of obtaining engagements through the use of card advertising is groundless. There is absolutely nothing in it from the standpoint of return for money spent. This spring a representative of a New York newspaper called up the office and stated that for a consideration it would publish the name of my firm together with the names of other firms and would state that all of the firms were New York accountants who would be pleased to undertake the preparation of New York state personal income-tax returns. The young lady who telephoned was quite incensed because I stated I was not at all interested and thought it would be a waste of money. This is a good illustration of the absurdity of advertising. In practically every case where a man has to file personal returns he will be more apt to need help in the preparation of his federal than his New York state return. If he prepares his federal return himself then, barring unusual circumstances, he will be able to prepare his New York state return. If he employs accountants to prepare his federal return, then for reasons of economy, if for no other, he will employ the same accountants to prepare his New York state return. Despite this reasoning, which I believe to be sound, the list of accountants willing to perform this service was of considerable length.

The firms with which I have been associated have occasionally placed cards in publications of clients, such as chamber-of-commerce magazines, when it was difficult to refuse. I recall one instance when we were reminded that the publication of such cards was permitted by the Institute. However, I do not recall that one dollar's worth of return ever came from such advertisements. In my opinion they are not only unpractical but undigni-

fied. Certainly reputable physicians do not advertise, although I heard of a case the other day which we might say was on the border-line. I can not vouch for the truth of this story but it seems that a young physician joined a golf club. He was asked if he would like his name stamped on his golf balls. After a moment's hesitation he said, "Yes, and under the name put on 'office hours two to four and seven to nine'." I do not propose to pass upon the ethics of this case but I do know that when we read advertisements of physicians we assume that the advertisers are quacks. In the case of this rule, as in that of solicitation, I feel that we should be more restrictive and should prohibit advertising whether by card or otherwise.

The twelfth rule relates to the participation by a member or an associate in any manner in the activities of a university, college or school which conducts its operations, solicits students, or advertises courses, by methods discreditable to the profession. This rule is so seldom invoked that I feel it does not require discussion.

I have a few more comments to make which, while they do not relate strictly to ethics, refer to the manner in which the profession is developing in high ideals and friendly associations.

I have noticed in the last two or three years the spirit of helpfulness which seems to be developing among the members of the Institute. I have observed a willingness to exchange opinions, to lend staff members when one firm has an engagement to perform which is larger than can be handled by the members of its own staff, to give advice, and even to lend the services of partners, in cases where a particular piece of work requires certain specialized knowledge. I hope that this willingness to help and coöperate may continue to increase.

Following the same general trend among accountants, I have also noticed the development of a disinclination to accept engagements which have been performed in a perfectly satisfactory manner by other accountants, unless there is a real reason for making a change. I recall that about three years ago there was a reorganization of a company whose accounts my firm had audited for some years. The reorganization brought in new capital and the bankers asked that the books be audited for a period of five years by a large firm whose name would add weight to the prospectus covering the sale of new stock. A prominent New York accountant was requested to make this five-year in-

vestigation. He inquired the name of the firm which had been making the annual audits. When he found that my firm had been the auditors for a considerable period of years he stated that he knew the partners of the firm and felt that we were trustworthy. He suggested that our reports be accepted and that we be engaged to draw up any figures which might be desired for use in the prospectus.

This was the first time I had ever heard of this sort of thing by an accountant. While his suggestion was not accepted by the bankers and he was required to make the examination, nevertheless I felt extremely grateful to him for the attitude which he had taken, although I felt that it was perhaps unnecessary for him to have been quite so fair as he was. However, I had an opportunity to find out that this attitude was entirely a practical one and I must admit that I found it out rather to my surprise.

A man whose business accounts we audit had established some years ago a half dozen small trust funds. The securities of the trust funds were invested by his broker and the books for the funds were kept in the broker's office. A quarterly audit was made by the same firm of accountants which audited the broker's books, a small firm but one with a high standing. My client requested me to meet him at his broker's office one day, and when I arrived he requested me to look over the books of the trust funds and give him an idea how much an audit would cost. When I found that he had been having the audits made by another firm I asked why he wished to make a change and found out that the only reason was because of his friendly feeling toward me. Having in mind the time when the shoe was on the other foot, I told him that I could see no reason for making a change on such a basis inasmuch as the other firm had been entirely satisfactory. The result was that we did not secure this engagement. Moreover, at the time my client was not wholly pleased with my attitude. The reactions, however, of which there were two, were worth far more than the engagement itself. In the first place about a month afterward my client came to me and said that he had given considerable thought to the matter. He had decided that our attitude was the proper one, and he respected us for not having wished to accept the engagement. The second development came through the attorney of this client. This attorney, who is a member of a wealthy family which has established a number of trust funds, heard of the incident from our mutual client. The attor-

ney approved of the position which we had taken and as a result decided to have us audit his family's trust funds. This engagement produced in annual fees twice what the other would have produced. The illustration is almost too apt, but I can assure you it is truthful. It convinced me that the attitude of my accounting friend who was reluctant to take my work was not wholly idealistic.

I believe that the modern tendency in our profession is toward the adoption of a more restrictive code of ethics and, beyond that, to the following of ideals which surpass ethics. Do not, however, give too much credit to the man who lives up to the highest ideals of the profession. He deserves not to be praised but to be complimented upon his sagacity, for, in my opinion, he has chosen the sure road to success.

Constructive Public Practice *

BY ALEXANDER RICHARDSON GRANT

After listening to the several excellent addresses already presented to us here, I feel it incumbent upon me to make certain apologies. What I have to say to you is derived from considerably shorter experience than most of you have enjoyed in the profession. My conceptions may recall to you the story of the editor who was confronted with the necessity of replying to a contributor who had presented a manuscript which was unacceptable to his publication. You may remember that his reply, among other things, contained the following statement: "What you have written is both original and good, but the part that is original is not good, and the part that is good is not original."

What I have to say to you has to do principally with the individual accountant rather than the firm.

It is not my desire to see the accountant at large become an industrial engineer. It is, nevertheless, entirely possible and, I presume, feasible for the firm of moderate to large proportions to have a department capable of functioning in this capacity. As a matter of fact, several firms have such departments at present. I feel, however, very much like Will Rogers when Dr. Funk threatened to sue him for defaming his *Literary Digest*. Will said that they compromised the difficulty by his agreeing to stop issuing the *Illiterate Digest* providing Dr. Funk would agree not to chew gum or throw ropes.

I hope you will not infer by what I may say that I am unmindful of the value to the public of properly prepared statements—accurately drawn balance-sheets and income reports. The accountant's contribution in these respects is of the highest social importance. It is unquestioned that the accountant must be prepared to certify to the financial and operating condition of a manifold variety of enterprises; and to act as master mechanic of bookkeeping. It is, nevertheless, the public's inclination to accept this contribution as constituting his entire scope.

Haven't you often heard it said of a certain type, "Why he's more than just an accountant?" But in reality he is not more.

* A paper presented at the annual meeting of the American Institute of Accountants, Colorado Springs, September, 1930.

He is exactly what I am talking about—a constructive accountant—a business man with a special training in the genuinely broad field of accountancy. He recognizes the necessity of accuracy. He utilizes the work of the man who has correlated the historical elements. Based upon this foundation, he plans for future operations, weighing hazards with benefits, and giving due consideration to the changes in commercial methods or in public demand. And the utility of his judgment is tempered only by the quality of his observations. Let us bear in mind, however, that a proper conception of what to observe is prerequisite to valuable results from observations.

There must always be the auditor, the systematizer, the practitioner with a talent for exactitude; but I feel that there is room for a distinctly constructive type, and I suggest that the modern public accountant, if you please, should be capable of embodying the historical, the analytical, the imaginative and the constructive. Why should not the accountant accept all of these elements as part of his proper function? What should he do with the knowledge he gathers in his unusual intimacy? He sits in the key position. He is a genuine *fidus Achates*. His may logically be the function of coordinator. Must he recite only that last year such and such happened—the year before such and such happened—which results in a difference of 3.4%? I agree perfectly that all this should be done. I am not by any means decrying the functions of the accountant that are generally accepted. I am only suggesting that from an economic standpoint there appear many functions which should be a part of the accountant's work if business as a whole is to absorb the maximum benefit to be derived from a group of people especially trained as accountants are trained. It is conceded that the qualified public accountant should have a rather general knowledge of law. Is it not equally reasonable that the accountant may be more valuable to his client if he has a fair working knowledge of the principles of economics, of the principles of industrial engineering, or, to be all inclusive, of the principles of modern sound business practice? To be sure, he must be an auditor capable of certifying to statements, but is he not qualified for the equally high function of business consultant? I think this is true.

But how often does the accountant, in insurance parlance, “deny liability” with respect to the many constructive elements of his subject. We require of ourselves that we have this general

knowledge of law. But we do not practise law. Our need for this knowledge is based on our function of coördinator. The same idea may, I think, be extended in the direction of industrial engineering and similar services.

I remember a few years ago I had occasion to make an examination of a company whose treasurer had been a former auditor. We had a series of disagreements on principle, which you might expect from a former auditor. Finally, in exasperation, this chap said to me, "Do you know what you auditors remind me of?" Being a curious soul, I confessed ignorance. He continued that some years prior to my entrance into public accounting he had been an auditor and had had occasion to make an audit of the — company. In examining the vouchers he had run across one which read as follows: "To — — (\$25.00 for testimonial): 'I have used — soap for some years and consider it an indispensable requisite of my toilet.'" "Now," said this chap, "that is what your audit reports remind me of"—and to be quite honest, gentlemen, I am more in agreement with this fellow than I would care to admit publicly. For the last few years, my association with investment and commercial bankers has convinced me that too many annual audit reports are similar to soap recommendations.

How many times are you called upon to analyze reports presented to you by your banking friend, and, after having given them thorough study, are forced to the conclusion that like the Two Black Crows, you haven't any idea why white horses eat more than black horses unless it is that your client has more of the white horses.

It is not beyond the function of the qualified accountant to have dynamic ideas. Agreed that he should never forget that he must never be wrong—must this element, however, be made forevermore exclusive as well as paramount? Must the accountant confine his activities to the historical? Must his function deal solely with the numbers of the past? Of course not. But doesn't there seem to be an inherent fear on the part of the profession at large to reach beyond the point of certification? Many of the leaders of the profession, nevertheless, are doing the constructive things to which I refer; although, for some reason or other, there seems to be reluctance on the part of the profession at large to admit these things as part of our proper practice.

It seems sufficient for an auditor to say that the cost of sales has gone up seven or eight per cent., but it seems quite beyond his function to state in his report that the marginal value of certain products has decreased eight per cent. and that the particular people in question have not kept pace with modern engineering methods—that they take raw material into the first floor; that they start their process on the second floor; that their second process is on the third floor; and that their final process is on the second floor and their shipping room on the fourth; and that they waste an immense amount of money back-tracking throughout the plant, and that this is why the cost of sales is seven per cent. too high.

We are part of an age of tremendous industrial development. Physics, chemistry and the other sciences alter our commercial activities almost daily. What was sound yesterday is no longer sound today. To all of these ephemeral conditions imagination must be applied. The profession of accountancy has, I think, rather discouraged the constructive, the imaginative forces of the mind.

I recall that some years ago, while an employee of another accounting firm, I was requested to make a survey of the city of Denver, for a client local to Chicago. This client had for many years maintained a store in Denver. I spent a week there. My assignment consisted of ascertaining whether or not the store should be closed. When I returned to my office the partners informed me that it would be much better if my report were rendered orally. They seemed to think that I had exceeded the scope of a public accountant to a large extent for I had made recommendations above and beyond their conception of his proper field. They probably thought I had been crystal gazing.

I have an idea that a careful check-up would result in the discovery of few genuinely constructive minds on the average staff. Is this due to the natural scarcity of constructive minds or is it due to the fact that, with the public's conception of public accountants as a sort of policemen, the men generally attracted to the profession are of the policeman type? I incline mainly toward the latter opinion. And in closing, may I leave you with the following thoughts:

(1) Would not a more constructive viewpoint on the part of the profession at large attract more constructive minds?

Admitting, as I do, that all men can not be of the type I describe—if, nevertheless, those of the profession who are its real

leaders would openly admit that the constructive side is a legitimate function, then would not the public at large have a more accurate picture of the talents of accountants and both the latter and general business profit thereby?

(2) There is the trial lawyer; there is the lawyer who is particularly able in the preparation of briefs; and there is the lawyer whose talents lie in slightly different directions. But they are all lawyers—all law trained.

Now by way of parallel. Can not the profession of accountancy contain men and women of slightly varying talents—all accounting trained? As a matter of fact, doesn't it contain several varying types?

(3) Might not our schools lay greater emphasis on sound business building without minimizing the authenticity of balance-sheets and income statements, but rather admitting that these are only part of a more comprehensive field?

(4) Would not the inclusion of some constructive questions in our regular examinations for fitness exert a decided influence on the type attracted to the profession?

(5) And finally, will you not agree that there is a possibility that the future of our profession and its advancement lies principally in a constructive and partly diagnostic service to modern business?

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department*.]

EXAMINATION IN AUDITING

May 15, 1930, 9 A. M. to 12:30 P. M.

Answer all the following questions:

No. 1 (10 points):

State the principal objects for which auditors' working papers are made and preserved.

Answer:

Auditor's working papers are prepared (1) to obtain and collect in usable form such data as are necessary to enable the auditor to prepare a report of the engagement; (2) to obtain a written record of work done to guide the auditor, and to serve as evidence of facts and statements presented in the report.

Auditor's working papers are preserved (1) to be used to furnish information which may be requested regarding the engagement or the report; (2) to assist the auditor in future engagements by obviating the necessity for investigation of certain transactions preceding such future engagements.

No. 2 (10 points):

Having received letters from several local customers questioning statements of account rendered them, your client engages you to make a detailed audit of the branch store from which the statements were sent. You direct a senior to make the audit after informing him of the circumstances. He finds in the course of a week many discrepancies for which the local cashier, who also keeps the books, offers vague and unsatisfactory explanations. At the close of a day the senior "as usual" (he says) puts all his working papers in his brief-case, which he locks and places in the store safe. The next morning he finds the office in confusion, the safe looted, and his brief-case gone—likewise the cashier. Several pages have been torn out of the cashbook, and the customers' ledger has disappeared. All this is reported to you and you take personal charge.

- (a) Will you complete or retire from the audit?
- (b) What fees, if any, will you charge your client?

Answer:

(a) The status of affairs should be reported to the client immediately with a request that he meet with the auditor at the branch for a discussion of the situation and of the course to pursue. At the meeting, the auditor should bring the following to the attention of the client:

- (1) That the cashier's actions clearly indicate irregularities chargeable to him;

(2) That the disappearance of the customers' ledger and certain cash-book sheets are a serious loss to the client, as he now has no record of the amounts due him from customers;

(3) That it is possible for the auditor, if he is engaged to do so, to build up relatively accurate accounts owing from customers by requesting confirmations of accounts from all known customers, using as his guide such records of billings and remittances as may be available and the files of correspondence with customers.

(b) The senior accountant used reasonable care when he locked the working papers in his brief case which he placed in the client's safe. The client should be charged at the regular per diem rate for senior accountants for each day of time spent by the senior on the engagement.

No. 3 (10 points):

What special facts should be ascertained and how may they be verified in a detailed audit of accounts of any one of the following:

- (a) Automobile dealers
- (b) Stockbrokers
- (c) Farmers

Answer:

(a) *Automobile Dealers.*

I. Verification and valuation of new and used car inventories. As soon as possible after beginning of the engagement, the auditor should make an actual inspection of all cars in the salesroom, warehouses, freight depots, service stations, etc., listing the make, type and factory number of each. Those not personally inspected should be confirmed by correspondence. The inventory of cars on hand at the balance-sheet date should then be determined by working back from the actual count by checking the entries in the car-record book against the purchases and sales made subsequent to the balance-sheet date. While new cars may generally be valued at cost, the auditor must take into consideration any factory price reduction on the current models made since the date of purchase or about to be made in the near future, and any obsolescence on any new cars of prior season's models which may have been carried over into the current season. Used cars, including cars used by the agency for demonstration purposes, should be valued at the estimated selling price, less the cost to put them in a salable condition, selling, and administrative expenses.

II. Instalment notes receivable. Instalment notes receivable representing time sales being financed by the dealer should be inspected and valued, and those out for collection, or discounted, should be confirmed by direct correspondence with the holders thereof.

III. Contingent liability on notes sold to finance companies. The auditor should request confirmations of all finance companies with which the dealer has been doing business to ascertain the amount of any contingent liability which may exist on account of instalment sales financed by such companies.

IV. Dealer's contract. The contract with the manufacturer or wholesale distributor should be examined to determine if he is adhering to the terms of the contract. The dealer may be required to deposit certain amounts for each car, or may be required to dispose of a certain number of cars per annum under penalty of losing his deposits or forfeiting his contract.

V. Salesmen's accounts. Salesmen's accounts should be reviewed in order to report their value. Advances to salesmen are frequent sources of loss to automobile dealers, and all accounts of doubtful value should be charged off.

VI. Sales of gasoline, etc. An examination of the records should be made to learn whether the total of the gasoline sales, both charge and cash, together with that used by the company, approximates the amount of gasoline purchased, less the inventory on hand. Such tests frequently disclose shortages.

(b) *Stock Brokers.*

Enumeration of special facts.

1. Security position.
 - a. Securities on hand
 1. Collateral
 2. Safekeeping
 - b. Securities in other locations
 1. At banks as collateral
 2. At banks for safekeeping
 3. At correspondent brokers
 - a. Collateral
 - b. Safekeeping
 4. In transit
 5. At transfer agents
2. Loans payable.
3. Customers accounts and position.
4. Due to and from brokers.

Manner of verification. At the close of business on the audit date the auditor should arrive at the client's office with his assistants after the securities have been locked up for the day. He should then take off the security position and customers' accounts from the records after all transactions have been recorded.

List of securities should be prepared, divided into the classifications shown above, to be used as counting sheets and verification guides. Letters requesting confirmations should be prepared and sent:

1. To the banks for loan balances, collateral, and securities held in safekeeping.
2. To correspondent brokers for balances and securities held.
3. To transfer agents for securities in transfer.
4. To others for transit items.
5. To brokers for amounts due to or from the brokers.

Copies of customers' margin records should be made, showing thereon debit and credit balances and security holdings, both collateral securities and safekeeping securities. Similar information should be obtained from the ledger accounts.

A copy of "security position" should be obtained for each security, showing the amount of each customer's holding and the location in total by classes of the securities: i.e., on hand, at banks, etc.

All of the above work should be accomplished the first evening.

In the morning the auditor must be present when the securities are brought out of the vault and must take complete charge thereof subject to supervision

by the company. The count of securities on hand should be made, and a complete control of the securities should be maintained until the count is completed.

The auditor can now proceed to balance the position by checking the confirmations and count against the security position, and also by checking the margin and ledger records against each other and against the security position. To determine equities in the various ledger accounts, market values should be applied to all securities which the customer is long or short, and these values should be compared with the debit or credit money balances.

The accounts can then be classified as secured, partly secured, unsecured, etc.

The remainder of the audit should be handled in the same manner as other audits.

(c) *Farmers.*

I. Amount and valuation of inventories. Inventories should include quantities on hand of grain, livestock and all farm produce available for sale and on hand to be sold. These items may be verified from inventory sheets which the farmer should have prepared. They should be valued at market prices less the cost of delivery to the market and less any other costs necessary to effect the sale thereof.

Livestock on hand held for farm use, dairying or breeding, should also be inventoried at fair market value recognizing such factors as age of the animal, productivity, etc. This inventory and that taken at the beginning of the period should be checked by the auditor. Additions to this class of livestock will be capitalized by being included in the inventory.

II. Distribution of labor costs. Labor costs should be analyzed to get the proper allocation of cost applicable to:

1. Products raised for sale during the year. This cost should be charged as an expense because the products will be included in sales or closing inventory at realizable sales values.

2. Cost of handling and caring for breeding, dairy, and work animals. This labor cost should be segregated for information purposes; the total however should be charged as an expense.

3. Cost of planting and developing orchards, clearing the land or preparing the land for planting should be capitalized.

The information and allocations indicated above should be verified by examination of the payrolls, investigation of duties of the employees, and discussions with the owner or manager.

III. Value of produce consumed by livestock and people on the farm. Proper charges should be made for produce consumed on the farm. This should be allocated to the proper expense accounts and credited to the inventory. Investigation will no doubt enable the auditor to ascertain the amounts of grain, etc. consumed on the farm.

IV. Valuation of farm property, buildings, equipment, etc. Carelessness and a lack of appreciation of the value of keeping adequate records on the part of the farmer requires the auditor to be especially careful in determining the valuation of farm property, etc. Payrolls and other records of expenditures should be carefully examined to learn if all additions to the farm property, either purchased or constructed, have been properly capitalized. It is possible for the auditor to make a personal inspection of the fixed assets as a

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part of the verification. Depreciation of the fixed assets should also be computed.

No. 4 (10 points):

The church of X engages you to audit the books and certify the annual report of its treasurer. You find that the revenues consist of open plate collections, pew rents, envelope pledges, donations and interest from an endowment fund. The expenses are those ordinarily to be found in such cases. A good system of depositing all receipts in bank and making all disbursements by cheque is in force.

Assuming that you find the books correct as far as you can verify them, write a brief report of what you have done, closing with your certificate.

Answer:

Board of Trustees,

"X," New York.

Gentlemen:

Having completed our examination of the accounts of the church of "X" for the year ended December 31, 1929, we submit our report thereon, consisting of comments and the following exhibits:

Exhibit A—Statement of assets, liabilities and net worth, December 31, 1929.

Exhibit B—Statement of income and expenditures for the year ended December 31, 1929.

Schedule 1—Schedule of investments—endowment fund—December 31, 1929.

Our examination included the verification of the assets and liabilities as of December 31, 1929, and a review of the income and expenditures for the year ended that date. It is to be understood that we did not make a detailed check of all the transactions of the period, but rather a test check of transactions for April and December, 1929.

FINANCIAL CONDITION

The cash in bank was verified by reconciliation of the bank account and a confirmation from the depository.

The investments in the endowment fund were verified by inspection. A list of the securities owned at December 31, 1929, showing the cost and the market value thereof at that date, is submitted in schedule 1; it will be noted that the market value at December 31, 1929, was \$. less than the cost of the securities owned. A reserve for this amount has been deducted from the cost of the securities shown in the balance-sheet.

The insurance policies in force were examined and it is our opinion that the church properties are adequately protected. The unexpired premiums as shown by the records were computed by us and found to be correct.

The land, church building, rectory, parish house and furnishings are carried at the appraised values set forth in the report of the "Z" appraisal company made as of December 31, 1929.

In so far as we were able to ascertain, all liabilities, including unpaid salaries, at December 31, 1929, were taken up on the books as of that date, and we were furnished with a certificate to that effect by the treasurer and the chairman of the finance committee.

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INCOME AND EXPENDITURES

As shown in detail in exhibit B, the income for the year ended December 31, 1929, was \$. in excess of the expenditures for the same period.

In the course of our examination we found that the plate and special collections were counted by the treasurer and verified by a member of the vestry who initialed the entry of the amounts in the collection register. Pew rentals were entered in a pew-rental register. The receipts from plate and special collections and from pew rentals were checked against the cashbook by us, and all receipts recorded in the cashbook were traced to the bank.

From the schedule of securities we ascertained the amount of interest receivable from the investments in the endowment fund and verified the receipt of such interest. We also prepared and mailed statements to pew holders for any pew rents in arrears, with a request to confirm the amounts. Sixty-five (65%) per cent of the total was confirmed without exception.

The payments of salaries were verified and the amounts paid were to be found in agreement with those set by the board of trustees.

We also verified the payments for operating expenses, missions, benevolences, etc., which were supported by authorized vouchers.

CERTIFICATE

We have audited the accounts of the church of "X" for the year ended December 31, 1929, and

We hereby certify that, in our opinion, the accompanying statements correctly reflect the financial condition of the church of "X" at December 31, 1929, and the receipts and expenditures for the year ended that date.

Very truly yours,

No. 5 (10 points):

In auditing the books of the A. B. Company you find an item of \$1,000 debited to notes-payable account, but no canceled note is produced in support thereof, nor can you find a similar amount previously credited to this account. For good and sufficient reasons you do not desire to question the officers of the company until you have more information regarding the transaction.

- (a) How would you proceed to obtain that information?
- (b) What may you expect to learn?

Answer:

(a) The debit to the notes-payable account of \$1,000 should be traced to the journal in which the transaction was recorded to determine, (1) the offsetting credit, and (2) the voucher or other papers supporting or authorizing the entry.

(b) If the entry represented a cash payment made, the auditor should inspect the canceled cheque to ascertain the date of issue, date of payment by the bank, the payee, and the endorsements. The signature on the cheque should be inspected to see if that was in order. The open accounts payable should be scanned to see if any account had been, or was being carried in the name of the payee, for the cheque may have been issued as a payment on an open account, or for some unrecorded liability.

It is also possible that a note was issued, entered in the notes-payable record but not entered in the notes-payable account, or that the cheque had been

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issued as a part payment on a note of a larger amount. A check of the entries to the interest-paid account may lead to important information.

If the "good and sufficient reasons" for not questioning the officers arose through some irregularity, suspected or otherwise, it is probable that one of the officers issued the company's note for \$1,000 for his personal use, and that when the note was presented for payment, the company's cheque was issued, either through carelessness, or on instructions of the officer.

It is also possible that the debit entry was made in an attempt to conceal a shortage in the cash account or in an attempt to "bury" a loan to an officer, employee, or others.

If the entry arose through the general journal, it may be found that the offsetting credit was made to some receivable account in an attempt to improve the current position of the company.

No. 6 (10 points):

Entering upon an audit of the A. B. Company you are handed the general books of account and a trial balance thereof. You learn that the company owns all or a controlling amount of the stock of several subsidiaries, carried on the books at cost. The trial balance shows open accounts with each of the subsidiaries.

State what influence this knowledge would have upon you, and why, in respect to

- (a) Proving the accuracy of the trial balance
- (b) The steps you would take

Answer:

The investments in the wholly owned subsidiary companies should be verified by ascertaining the authority for the purchases of the stock of the companies by reference to the minute book and contracts covering the transactions, and by tracing the actual payments. The open accounts should be carefully analyzed as to the nature of the transactions which should be checked. The balances in these accounts should be confirmed by direct correspondence.

Even though the open accounts arise from sales to the subsidiaries, the balances should not be included with the accounts or notes receivable from customers. If the net current assets of a subsidiary are in excess of the amount which the company owes to the controlling company for purchases, the balance due may be shown in the balance-sheet of the controlling company as a current asset. If the open accounts represent advances of a permanent nature, the balances should be considered as additional investments and shown with the investments in the subsidiaries under the caption "Investments."

Unless the books of the subsidiary companies are audited, the investments in those companies should be stated at cost, and the certificate qualified accordingly. The fact that these investments are in wholly-owned companies, should be noted on the balance-sheet.

The auditor should make every effort to convince the officers of the A. B. Company of the desirability of having the books of the subsidiaries audited so that a consolidated balance-sheet can be prepared. In lieu of investment accounts in and open accounts with wholly-owned subsidiaries, assets and liabilities of like kind of all the companies would be consolidated so as more clearly to reflect the financial condition of the companies as a whole.

No. 7 (10 points):

State three methods, with your arguments for and against each one, of showing as an investment the premiums paid by a corporation on a policy in its favor on the life of its president.

Answer:

Three methods for showing as an investment the premiums paid by a corporation on a policy in its favor on the life of its president may be stated as follows:

1. The capitalization of the net premiums (i.e., premiums, less any dividends) paid.
2. The capitalization of the net premiums paid with a reserve accumulated by charges to profit-and-loss.
3. The capitalization of cash surrender value of the policies only.

Insurance is generally carried on the life of the principal officer of a corporation to aid the company to meet any material emergency arising because of the death of the officer. Even though he may continue active beyond his life expectancy, and the policy be continued in force, the amount of the insurance received at the time of his death will exceed the amount of the premiums paid. Because the amount ultimately received will be in excess of the amount of the premiums paid, it is contended that the asset is built up as the premiums are paid, and, therefore, the premiums should be charged to an asset account. However, it can not be known that the policy will be kept in force until the death of the officer. If canceled before that time, the excess of the premiums paid and capitalized over any cash surrender value will have to be written off to surplus.

As against capitalizing the premiums, there are some who contend that the premiums should be written off currently, as paid. This method open to criticism in that a secret reserve is being created, inasmuch as the balance-sheet does not disclose the fact that the life of the principal officer is insured in favor of the company. This objection is met by the advocates of the second method enumerated above. The method of carrying a reserve equal to the amount of the premiums capitalized is predicated upon the theory that the insurance is carried against a future loss, and that it is, therefore, necessary to create a reserve out of current profits against which the loss may be charged.

The third method of capitalizing only the cash-surrender value of the policies is a compromise, in that, after the second or third year, the premium is divided; a part being charged to expense and a part to an asset account. This method is more generally followed, because the amount carried as an asset may be converted into cash upon the surrender of the policies. The objection raised against this method is that the spread between the face value of the policies and the cash-surrender value is reduced each year, with a corresponding reduction in the protection afforded by the insurance.

In no case should the premiums capitalized or the cash surrender values be shown as a current asset.

No. 8 (10 points):

In auditing the books of Roe & Co. you find among the notes receivable one endorsed by John Doe, which is six months overdue, the maker having refused to pay it. You learn that Roe & Co. have neglected to notify John Doe of the default.

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At the same time you happen to be auditing the books of John Doe, have already learned of this endorsement and propose to show it in a footnote on his balance-sheet as a contingent liability, with his knowledge and consent, though he "thinks" it has been paid.

Bearing in mind that, under the laws of the state in which this transaction occurs, John Doe is now discharged as endorser, how will you handle this matter in order to show it correctly on the respective balance-sheets?

Answer:

In the course of auditing the books of Roe & Co., a "request for confirmation" should be sent to John Doe, asking him to indicate his liability, if any, to Roe & Co., for the discounted note endorsed by him, which was still unpaid. The manner in which this matter would be handled in the respective balance-sheets would depend upon the answer received from John Doe.

If Doe replied that he was not obligated in the matter, under the laws of the state, the amount of the note, being uncollectible, should be written off, and the net worth reduced correspondingly in the balance-sheet of Roe & Co. On the balance-sheet of John Doe, the matter could be ignored entirely.

If Doe replied that he recognized his liability and was willing to pay the note when convinced that he had not already done so, the amount of the note should be shown on the balance-sheet of Roe & Co., as "notes receivable—past due," and included with the current assets. On the balance-sheet of John Doe, the amount of the note should be shown as "notes payable" and included with the current liabilities. The net worth of John Doe should be reduced by the amount of the liability thus set up.

The foregoing answer is based upon the assumption that the maker of the note was not financially responsible. If, however, the maker was financially responsible, the amount of the note should be transferred to accounts receivable and its collectibility considered by the auditor in setting up a reserve for doubtful accounts. Roe & Co. should press the maker for payment of the amount due, for their own protection in case Doe refused to waive his discharge under the laws of the state, and to reimburse Doe in case he paid the note as endorser.

No. 9 (10 points):

State in detail the proper methods of verifying the securities owned by a "fixed investment" company.

Answer:

A schedule should be prepared from the securities ledgers just prior to the date of the actual count and inspection of the securities, showing:

- Dates of purchases.

- Description of the securities, including the certificate or bond numbers.

- Number of shares of stock or the par of the bonds owned.

- Par value of stock, if any.

- Where the securities are deposited, if not on hand.

- Cost and market price of the securities.

- Interest and dividends received.

- If the securities are posted as collateral, with whom, and for what purpose.

The securities on hand should be examined by the auditor in person (a representative of the trust should be present) and checked against the schedule

previously prepared—preferably at the close of business on the balance-sheet date. In any event, complete control must be maintained until all have been verified to prevent substitution. Securities out for transfer, delivery, safe-keeping or collateral should be verified by direct communication with the transfer agents, depositaries, etc. The schedule of securities should be checked against the investment account or accounts in the general ledger to ascertain that the balances are in agreement.

In his examination the auditor should determine (1) that the bond coupons which are due subsequent to the date of his examination are intact, and (2) that the stock certificates are in the name of the company, or that they are endorsed or accompanied by powers of attorney if in the names of persons.

Purchase confirmations should be checked against the purchase records. The dates should be especially noted. Brokers' sales slips should be checked against the sales records; and here also, the dates should be carefully noted. Tests of the purchases and sales prices should be made against official price records, and of the extensions and other calculations. The footings and cross-footings of the sales and purchases records should be verified, and the postings to the investment accounts should be checked.

The dividends and interest record should be checked against the official list of dividends declared and interest paid to see that the total dividends and interest receivable to the company have been received and recorded.

The securities schedule should be checked with that prepared for the previous audit, and securities no longer owned should be traced through the cash-receipts book to the bank statement to account for their disposal. If the number of purchases and sales during the period were few, a detailed audit of such transactions is to be recommended.

In planning his work, the auditor should arrange for the audit of the cash accounts and other negotiable securities simultaneously with the audit of the security portfolio.

No. 10 (10 points):

A purchased bonds in 1910 for \$100,000. Their fair market value March 1, 1913, was \$112,000. He sold them in 1929 for \$90,000. His only other income for 1929 was a salary of \$45,000 and interest \$5,000, with no deductions claimed. Disregarding any exemptions or credits to which he might be entitled, show the calculations you would make to ascertain the income-tax A will have to pay. (Surtax on \$50,000 is \$2,980; on \$28,000, \$720.)

Answer:

The authority for the following calculations is section 101 of the revenue act of 1928 from which the following is quoted:

"(b) Tax in case of capital net loss.—In the case of any taxpayer, other than a corporation, who for any taxable year sustains a capital net loss (as hereinafter defined in this section), there shall be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted, and the total tax shall be this amount minus 12½ per centum of the capital net loss; but in no case shall the tax of a taxpayer who has sustained a capital net loss be less than the tax computed without regard to the provisions of this section."

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"(c) Definitions (for the purposes of this title):

(2) 'Capital loss' means a deductible loss resulting from the sale or exchange of capital assets.

(6) 'Capital net loss' means the excess of the sum of the capital losses plus the capital deductions over the total amount of the capital gain.

(7) 'Ordinary net income' means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deduction.

(8) 'Capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), . . ."

The bonds which "A" purchased in 1910 and sold in 1929 must be considered as "capital assets" and the resulting loss, therefore, a capital loss. The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (1) the cost of such property, or (2) the fair market value of such property as of March 1, 1913, whichever is greater. (Section 113 (b) of the revenue act of 1928).

STATEMENT SHOWING COMPUTATION OF TAX

Ordinary net income:

Salary	\$ 45,000.00
Interest	5,000.00
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Total ordinary net income	\$ 50,000.00
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Capital net loss:

Fair market value of bonds as of March 1, 1913	\$112,000.00
Selling price of bonds	90,000.00
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Capital net loss	\$ 22,000.00
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Computation of Tax

\$ 4,000.00 at $\frac{1}{2}$ per cent	\$ 20.00
4,000.00 at 2 per cent	80.00
42,000.00 at 4 per cent	1,680.00
Surtax on \$50,000.00	2,980.00
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Total tax	\$ 4,760.00
12 $\frac{1}{2}$ per cent of capital net loss (\$22,000.00)	2,750.00
	<hr/>
Balance of tax	\$2,010.00
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However, it is also necessary to compute the tax "without regard to the provisions" of section 101.

Ordinary net income	\$ 50,000.00
Less capital net loss	22,000.00
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Net income subject to normal and surtax	\$ 28,000.00
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<i>Computation of Tax</i>	
\$ 4,000.00 at $\frac{1}{2}$ per cent	\$ 20.00
4,000.00 at 2 per cent	80.00
20,000.00 at 4 per cent	800.00
Surtax on \$28,000.00	720.00
Total tax	<u>\$ 1,620.00</u>
"A" will be required to pay the larger amount, or	<u>\$ 2,010.00</u>

ILLINOIS ACCOUNTANCY EXAMINATION

This department has been requested to answer the following question set by the board of examiners in accountancy, University of Illinois, in the examination in auditing, May 15, 1930.

Question:

In connection with the audit of the "Y" Corporation, you find an account called "land and buildings," which has been charged with the following:

<i>Date</i>	<i>Particulars</i>	<i>Amount</i>
2/ 1/29	Attorneys' fees in connection with organization of the company	\$ 1,000.00
2/ 6/29	Cost of land and old building	112,400.00
2/28/29	Discount on sale of stock	15,000.00
2/28/29	Miscellaneous organization expenses	518.12
2/28/29	Cost of razing old building	2,546.00
3/17/29	Attorneys' fees and expenses in connection with the purchase of land and old building	2,000.00
3/31/29	Stock bonus given to promoters; 150 shares of preferred stock—par value \$100 each	15,000.00
3/31/29	Administrative and general expenses, February and March	6,318.13
4/15/29	Total cost of new building erected	96,318.63
4/15/29	Discount and expense on bonds	5,000.00
5/ 6/29	Real estate taxes	1,850.33
5/31/29	Administrative and general expenses, April and May	14,419.64
10/15/29	Interest on bond issue	3,250.00
Total per books		<u>\$275,620.85</u>

You also find that:

- (1) The "Y" Corporation was organized January 2, 1929.
- (2) The bond issue was for the purpose of paying for the cost of the building, is dated 4/15/29, bears a $6\frac{1}{2}\%$ interest, and is payable semi-annually.
- (3) Real estate taxes of \$1,850.33 were deducted from the purchase price of \$112,400 and were credited to organization expenses at February 6, 1929.
- (4) On February 28, 1929, the balance of \$518.12 in the organization expense account was charged to land and buildings.
- (5) The normal operations of the business commenced July 1, 1929.
- (6) Administrative and general expenses consisted of:

Officers' salaries	\$16,000.00
Factory superintendent's salary	3,000.00
Supplies, light, heat, etc.	1,737.77
Total	<u>\$20,737.77</u>

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- (7) Other than reviewing the plans, blue prints, etc., neither the officers nor the factory superintendent were connected with the construction of the new building.

In order that depreciation may be properly computed, you are to set up separate accounts for land and buildings, stating your reasons supporting the various kinds of items which you include in each account.

In case certain charges found in land and buildings are not, in your opinion, properly chargeable to either land or buildings, state what disposition you would make of them.

Answer:

"Y" CORPORATION

Land Account

<i>Date</i>	<i>Description</i>	<i>Amount</i>
Feb. 6, 1929	Cost of land and old building The contract price of the land and old building which is to be razed is a proper charge to land account.	\$112,400.00
Feb. 28, 1929	Cost of razing old building Inasmuch as it was necessary to raze the old building before the new building could be erected, and as it was not the intention of the corporation to use the old building, the cost of that structure and the cost of razing it is a proper charge to the land account. Some writers suggest that the cost of razing the old building should be charged to the cost of the new building. As the value of the new building is not increased by the expense of razing the old building, such a charge should not be made.	2,546.00
March 17, 1929	Attorneys' fees and expenses in the purchase of land and old building are additions to the cost of the land	2,000.00
	Total	<u>\$116,946.00</u>

"Y" CORPORATION

Building Account

<i>Date</i>	<i>Description</i>	<i>Amount</i>
April 15, 1929	Total cost of new building erected	\$96,318.63
July 1, 1929	Accrued interest on bonds for the period April 15, 1929 (date of issue), to June 30, 1929 (the normal operations of the business commenced July 1, 1929), may be charged as a part of the cost of the building which was financed by the issue of \$100,000 of 6½% bonds	1,354.17

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"Y" CORPORATION Building Account (continued)

<i>Date</i>	<i>Description</i>	<i>Amount</i>
July 1, 1929	Amortization of bond discount for the period April 15, 1929, to June 30, 1929, should also be charged to the building cost for such amortization is, in effect, interest. While the nominal coupon rate of interest is $6\frac{1}{2}\%$ per annum, the effective rate of interest is the coupon rate, plus that portion of the bond discount applicable to the period. The question fails to state the life of the bonds, but for the purpose of this answer, the life is considered to be 20 years. As the annual charge for bond discount amortization would be \$250 ($\$5,000 \div 20$), the charge for the $2\frac{1}{2}$ months of the construction period would be.....	52.08
	Total.....	<u>\$ 97,724.88</u>

In view of the fact that the examiners did not state the life of the bonds over which the bond discount and expense could be amortized, it is believed that the candidate could not be criticized if he made no assumption as to the life of such bonds in order to determine the amount to be capitalized. However, as the interest accrued during the period April 15, 1929, to June 30, 1929, was capitalized in the above solution, it was considered necessary to make such an assumption, in order to capitalize the additional interest represented by the bond discount for the same period. It should also be noted that some writers would not consider the interest as a part of the cost of the building.

The other items appearing in the account called "land and buildings" should be treated as follows:

<i>Date</i>	<i>Particulars</i>	<i>Amount</i>
Feb. 1, 1929	Attorneys' fees in the organization of the company should be charged to organization expense.....	\$ 1,000.00
Feb. 6, 1929	The real-estate taxes of \$1,850.33 (note 3) were assumed by the vendor of the land and old building, and deducted from the cost of such land and old building by the "Y" Corporation. The amount should be charged to organization expense (which had been credited in error) and credited to accounts-payable account....	1,850.33
Feb. 28, 1929	Discount on sale of stock should be charged to an account called "discount on capital stock"—a deferred charge to be written off against surplus in the future.....	15,000.00
Feb. 28, 1929	Miscellaneous organization expense should be charged to organization-expense account.....	518.12

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March 31, 1929	Stock bonus given to promoters should be charged to organization expense as it represents a part of the cost of organizing the corporation	15,000.00
March 31, 1929 and May 31, 1929	Administrative and general expenses for February, March, April and May. These expenses were not incurred in the acquisition of the land or the erection of the building so can not be properly charged to either of these accounts. However, if it were found that some part of the supplies, heat, light, etc., were used in the erection of the building, they may be charged to the building account. Otherwise, the total of the administrative and general expenses for the period should be charged to organization expense ..	20,737.77
April 15, 1929	Bond discount and expense should be charged to the account of like name. That portion charged to building cost, \$52.08, should be credited to the bond-discount account, which is a deferred charge to be written off over the life of the bonds	5,000.00
May 6, 1929	Real-estate taxes should be charged to the accounts payable set up in the second entry above	1,850.33
Oct. 15, 1929	Interest on bond issue should be charged to the expense account "bond interest," which was credited with the \$1,354.17 charged to building cost	3,250.00

Book Reviews

FRAUD, ITS CONTROL THROUGH ACCOUNTS, by GEORGE E. BENNETT, *The Century Company*, New York.

Fraud, Its Control Through Accounts is a valuable addition to what has already been written on the subject of fraud. Professor Bennett has covered a great deal of ground in one hundred and twenty pages. The subject matter is logically presented beginning with a chapter on the legal distinction between larceny, embezzlement and forgery followed by an outline of certain general principles relating to accounts and ending with a complete summary of the kinds of fraud perpetrated through purchases, sales, cash and payrolls. The whole matter is presented in a terse yet thorough style.

This book, which is published under the auspices of the American Institute of Accountants, should prove a valuable guide to all practising accountants. In the detection of fraud and in the installation of accounting systems it is important to know where irregularities are likely to develop. This book indicates the weak points and shows the way to strengthen control. In this respect it should also be of value to executives, controllers and auditors in planning their accounting and other departmental organization, as well as the method by which transactions shall flow through the books.

F. H. HURDMAN.

STOCK BROKERAGE AND INVESTMENT HOUSE ACCOUNTING, by F. W. THORNTON, *Harper and Brothers*, New York. 188 pages.

Stock Brokerage and Investment House Accounting is a clear and concise exposition of stock-brokerage accounting. Mr. Thornton has avoided, if not dispelled, that air of profound mystery which, in some quarters, surrounds the subject. He has set forth, in their proper perspectives, the distinctive features that one encounters in this field of accounting.

In the first section of the book, Mr. Thornton deals with the different types of transactions of a stock broker and the principal books of account and shows, by appropriate examples, how the transactions are recorded. Lucid explanations are given of the use of the blotter and position record, the meaning of failures to receive and deliver, stocks borrowed and lent, transfers, etc., and their place in the accounting.

The book appears to be written largely for the benefit of the public accountant whose clientele includes brokerage firms and for members of his staff. For this reason a glossary might be useful.

The chapter on auditing procedure is excellent. With an economy of words that is refreshing, Mr. Thornton emphasizes the essential differences between the audit of a stock-broker's accounts and that of a commercial concern. Accountants of experience in brokerage audits will find much of interest in this chapter; a perusal of it will probably suggest points on which they can improve their own procedure and thus increase the protection for themselves and their clients. Mr. Thornton, however, does not mention that a broker's insurance policy sometimes requires that second requests for confirmation must go by registered mail. He makes the somewhat naïve suggestion that the audit

Book Reviews

should be commenced on a Friday night, so that the counting of securities, etc. can be completed by Monday, the next day for deliveries. Unfortunately, public accountants have to take things as they come. Clients generally ask for the audit to be as of the close of business on the last day of the month, and that day sometimes will fall on, say, a Tuesday or Wednesday. However, some prevision on the part of the public accountant and the adoption of a well laid out programme will reduce undue late work for his staff, without interfering with the smooth working of the client's office.

There are, of necessity, many references throughout the book to the New York stock exchange and its regulations. Probably the most important development of recent years in the field of stock-brokerage accounting, at any rate as affecting public accountants, has been the requirement of the exchange that members shall report their financial condition to it when required, the statement being generally referred to as the "questionnaire." True, part of the questionnaire is reproduced in Mr. Thornton's book, but the introductory references to it seem rather casual and there does not appear to be enough emphasis as to how important it is that public accountants should acquaint themselves with the requirements of, and procedure relating to, the questionnaire. This reviewer suggests that, in a book on stock-brokerage accounting and auditing procedure, it is advisable to set forth clearly and definitely the requirements of the stock exchange as to the questionnaire and the procedure as affecting the public accountant.

The author states that under the income-tax law securities owned by brokers or dealers may be valued either at cost or at market prices. This reviewer believes that there is a choice of three methods: (a) cost; (b) cost or market, whichever is lower; or (c) market.

The second section of the book deals with the accounts of investment security dealers, i. e., those who sell securities to their customers, as principals and not as brokers. It contains a well rounded treatment of the matter.

Mr. Thornton has made an illuminating and readable contribution to the literature of accounting procedure for brokers and dealers in securities.

J. S. WILLIAMS.

TAX AVOIDANCE, by DENNIS HARTMAN. *The Legal Publishing Society, Inc.*, Washington, D. C. 224 pages.

It has been said that the difference between a patriot and a rebel lies in the degree of success. Perhaps in tax practice something of the same kind may be said—if a procedure to reduce taxes is successful, it is avoidance and legal, but if it fails, it is evasion and illegal.

The book has outlined in a general way a number of suggestions whereby taxes may be reduced. One of the best chapters in the book is the author's discussion of the use of trusts. In this he gives a quite thorough and well documented discussion of this interesting topic. While trusts are not so generally used as other types of organization, still the subject is an intricate one, requiring careful study in its application, and the author has brought together a large amount of data relative to it. The chapters on the use of corporations, both from the standpoint of reorganizations and the use of the individual corporation, are also quite complete. However, it would have added considerably to the

enlightenment of the average practitioner as to the use of Canadian corporations if he could have had the benefit of Mr. Hartman's more extended views and comments. This phase of the discussion was confined almost entirely to what appears to be the author's quotation from a pamphlet.

The good features of the book are somewhat obscured by a rather poor arrangement in the matter of separating quotations from the author's comment and by poor proof-reading. It is quite apparent that Mr. Hartman hurried the completion of the book in order that it might be in the hands of purchasers in time to be available for the current tax season and future editions of the book will undoubtedly be corrected.

E. T. WEILER.

THE KEYS OF BETA ALPHA PSI. Official publication of the grand council of Beta Alpha Psi.

The first issue of the national publication of Beta Alpha Psi, national accounting fraternity, made its appearance on September 1, 1930, the result of months of basic planning on the part of the members of the grand council. A national news organ, properly constructed, should occupy a major portion of each year's programme, if for no other reason than that it knits together more firmly members scattered over the land both in and out of local chapter activities. Plans are under way to make every issue of vital interest to every member of the fraternity.

This publication is to contain articles in harmony with suggestions which have been sought from local officers and members. These articles will concern ethics of practice, professional training, coöperation with local practitioners, and so on.

Beta Alpha Psi is a Greek letter fraternity for accounting majors in schools and colleges of business administration. The first chapter was founded at the University of Illinois in 1919, and in 1923 the fraternity was incorporated under the laws of Illinois as a corporation not for profit. The idea which lies behind the activities of this fraternity is to elevate the standing of the profession of accountancy through improving the quality of its members who are recruited from the universities.

Before candidates are admitted to membership, even if acceptable on general grounds, written entrance examinations must be passed, searching in nature and designed to test the thoroughness of preparation of each candidate in accounting theory, in problems, in auditing, in business law and in economics.

An organization imbued with this idea, and numbering among its members accountants standing high in the profession as practitioners or teachers or both should put forth a publication which will take its place alongside the best in accounting literature.

GEORGE E. BENNETT.

COMMERCIAL ARITHMETIC, by WARREN L. STARKEY, *Globe Book Company*. 179 pages.

The purpose of this comparatively brief, little book is not only to cover the essentials of commercial arithmetic thoroughly and concisely, but also to explain them in what the author, after many years of successful teaching experi-

Book Reviews

ence, has found the clearest and most satisfactory manner. The book is primarily written for secondary school and technical business school students.

Throughout the volume praiseworthy emphasis is laid upon developing a general, systematic, rational method of solving all practical problems. As an aid to the student, the author constantly analyzes, reasons and solves illustrative problems in a model manner. One instrument whose applicability to many outwardly dissimilar but inwardly related problems is continually explained, with excellent effect, is the percentage formula. Hence, upon careful completion of this book, a reader can forget many details and still have received in his training a means to mastery over the usual problems in commercial arithmetic.

Regarding its detailed subject matter, this little volume, in addition to the topics customarily found in a work of similar scope, introduces several new subjects worthy of inclusion and treats many old ones in a simpler and more stimulating way. And concerning its style of presentation, the book, because of the many illustrative problems solved, the definitions, diagrams, rules and formulæ, is unusually simple and clear.

In view of the merits above, and the additional one of very low price, this book should not only prove valuable in secondary school instruction, but also quite useful to all practising accountants who desire a rapid survey of commercial arithmetic essentials, and especially to any who, in satisfying the educational requirements for a New York C. P. A. certificate, expect to be examined, by the state board of regents, in commercial arithmetic.

HENRY W. SWEENEY.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

DISPOSITION OF ITEMS ON BALANCE-SHEETS

Question: I would greatly appreciate, as an associate member of the Institute, specific enlightenment as to the proper disposition on the balance-sheet recommended of such ordinary items as call loans, commercial paper, tax anticipation notes, mortgage notes, bankers acceptances and similar media for the temporary investment of current surplus corporate funds.

Answer: Your inquirer asks for enlightenment as to the proper disposition in the balance-sheet of "such ordinary items as call loans, commercial paper, tax anticipation notes, mortgage notes, bankers acceptances and similar media for the temporary investment of current surplus corporate funds." It is difficult to answer such a general inquiry as from its wording one can not well determine whether your inquirer wishes information about each of the items individually or information as to the general treatment of temporary investments of surplus funds. Assuming the latter to be the purpose of the inquiry, it is the writer's opinion that it is always proper and usually desirable to classify temporary investments of current surplus corporate funds as current assets. To justify such classification, however, it should be definitely determined that the asset actually represents a temporary investment which can be exchanged for cash whenever desired and is not intended as a permanent investment. In any case, it is desirable that the description of the asset so included among the current assets should be as clear and definite as possible.

Answer: The items listed are temporary investments of current surplus corporate funds and are properly classified on a balance-sheet as "marketable securities" and are properly included in the designation "current assets."

Answer: If this question is read carefully it would appear that an error had been made in stating it. However, we can interpret the sense of this question to mean the proper disposition on the balance-sheet of the various items set forth in the question.

A company having on hand more cash than it needs for its current purposes frequently invests these funds temporarily for the purpose of the return which is afforded by such investment. The fact that this disposition of funds is temporary makes it necessary to seek sound investments which may be liquidated without loss at the time the need for cash may arise. It is necessary to seek investments which have a ready market value or mature on or before the time when the need for cash may arise.

We understand that current assets are those assets which, in the ordinary course of business, may be converted into cash to pay liabilities without crippling or restricting the activities of the business. So long as the investments continue to be readily marketable or of an early maturity date they answer the description of current assets. It will be noted that on the balance-sheet current assets are arranged usually in their order of liquidability and for this reason cash is placed first, accounts receivable follow and inventories are placed last. These three items do not, of course, include all current assets but are merely stated for purposes of illustration. Following this practice, therefore, it is recommended that the media for the temporary investment of funds be classified on the balance-sheet in the same manner, that is, in their order of liquidability. As an illustration, call loans which supported by proper collateral are about as liquid as cash and are usually placed on the balance-sheet immediately below that item.

*EARNINGS OF FIRE AND CASUALTY
INSURANCE COMPANIES*

Question: "In computing the earnings which accrue to a stockholder of a fire or casualty insurance company during a period of one year, the underwriting profit or loss, the net interest, dividends and rents earned, and net profit or loss on investments are added together. Some firms also include 40 per cent. of the increase in the unearned-premium reserve for the year. They justify this by stating that it reflects the increase in the liquidating value of the stock. (The liquidating value of a fire or casualty company stock is obtained by taking the capital, surplus, voluntary reserve, and 40 per cent. of the unearned premium reserve.)

"On the other hand, it is claimed that since the reserves revert to underwriting profits as soon as the policy expires, this should not be taken in computing the total earnings.

"Since taking in the 40 per cent. of the increase in U. P. R. usually tends to inflate the profits, we feel that the more conservative way is to omit that figure."

Answer: We do not believe that 40 per cent. of the unearned premium reserve should be used in computing the earnings of the company.

This would only be obtained by reinsuring the open risks, which would contemplate liquidation, and the 40 per cent. is not a fixed amount but subject to negotiation and any special conditions of the business of the company being taken over.

Usually in a fire insurance company there is also an equity in the unpaid losses, as normally there is a saving between the losses as estimated and paid. There are also possible equities in undervalued real estate, office furniture and

fixtures and the goodwill value of an established agency organization. These matters would require consideration in the sale of a company but hardly in finding its earnings.

In conclusion we may point out that the state insurance departments do not permit the inclusion of the 40 per cent. in their determination of surplus.

Answer: A credit to income account of the character indicated in your letter may perhaps more clearly be described as a "part deferment of the estimated cost of acquisition of unearned premium income." No such income credit is permitted by state insurance departments to be included in annual statements filed by insurance companies, nor is it the usual practice of insurance companies to record it on their own books. If auditors, however, should find in the course of an examination that credit has been so taken they would, we consider, be justified in passing the accounts, provided the amount of deferred cost and the basis of its computation is clearly shown on the face of the balance-sheet.

The balance-sheet of any business carried on for the purpose of gain is usually prepared on the basis of the company being a "going concern," and does not attempt to reflect the liquidating value of shares owned by a stockholder in the company. In the event that an insurance company in preparing its balance-sheet follows the more usual practice of not deferring the approximate cost of acquisition of unearned premiums, the liquidating share value is less nearly reflected by the balance-sheet to the extent of the item not deferred. It may be mentioned that statistics relating to insurance companies' balance-sheets usually give effect to this deferment in the computation of share values.

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[Photostatic reproductions (white printing on a black background) of most of the articles listed in THE JOURNAL OF ACCOUNTANCY or *Accountants' Index* may be obtained from the library of the American Institute of Accountants, 135 Cedar Street, New York, at a rate of 25 cents a page (8½ in. x 11 in.), at 35 cents a page (11½ in. x 14 in.), plus postage. Members and Associates of the American Institute of Accountants are entitled to a discount of 20 per cent. Identify the article by author, title, name of periodical in which it appeared, date of publication and paging. Payment must accompany all orders.]

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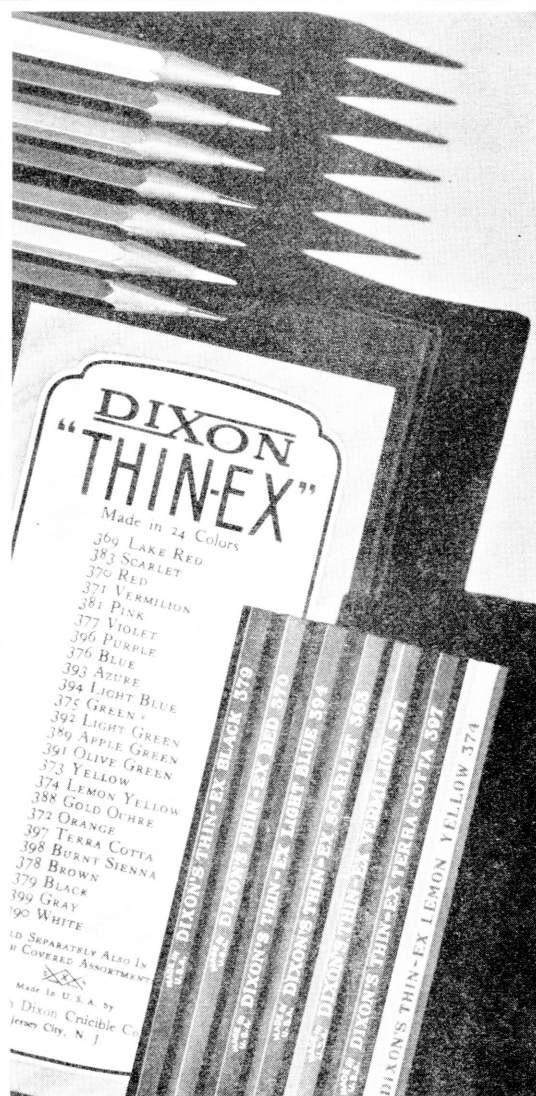
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